



HOT SHEET

A publication by the California Land Title Association's Claims Awareness Committee

EXTRA! EXTRA!

Emerging Claims – Unauthorized Recons Surface

New claims are coming in to title insurers based on deeds of trust that have been reconveyed by a substitution and reconveyance, when in fact the party purporting to make such reconveyance has not been granted that right by the lender. There is evidence that some policies have already been written in reliance upon such documents.

The validity and legality of the reconveyance are marketed to homeowners/borrowers by advising them of certain theories supporting the release of the mortgage lien, the fallacies of each which are clearly apparent to the title industry. The more common of the two seems to be that when the lender sells the note into the secondary market, the lender has been paid and the deed of trust must then be reconveyed. This theory ignores the fact that what has been sold is the right to receive the repayment of the original loan, and that the purchaser of the note and deed of trust has stepped into the position of the original lender, and is entitled to the payments and to all of the other features of the note and deed of trust.

The second theory is that the deed of trust, as a security for the repayment of the debt, can unilaterally be replaced with a bond. This ignores the position of the lender

that has made the loan in reliance upon a specific security, and has no duty or obligation to accept a substitute security. In addition, the bond purportedly utilized under this theory does not appear to be one written by an admitted surety in the State of California, and certainly has not received the approval of the lender despite any signature of one purporting to act as attorney in fact for the lender.

The paper trail for this substitution and reconveyance mechanism typically begins with a conveyance to D. Scott Heinemann as trustee of what appears to be a legitimate family trust. There follows a substitution of trustee of the deed of trust, executed by Mr. Heinemann, with an attachment purporting to be a grant of power of attorney to Mr. Heinemann by the beneficiary of the deed of trust. The grant of power of attorney is executed by Mr. Heinemann, citing as authority certain UCC Sections. Next, of course, comes a "reconveyance of deed of trust" executed by Mr. Heinemann as substituted trustee. A signature on behalf of the true beneficiary is not found among these documents; nevertheless, they have been accepted for recording and are indexed.

A variation on the theme involves the recording of a "bond" purportedly running in favor of the

beneficiary. This bond appears to be underwritten by an offshore entity, with somewhat convoluted language ending up with most of a paragraph in German, allegedly establishing the assets underlying the bond. The "bond" is intended as a substitute for the security interest created by the lien of the deed of trust, with the acquiescence of the lender to this device

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Volume 16 Number 2 February 2005

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PRINT THIS HOT SHEET EDITION

directly from www.clta.org
under "Industry News"



Defeasance: What is it? Why do we care?

By: Keith Pearson, Associate Senior Underwriter
First American Title Insurance Company

Some of you may have heard the term defeasance as part of your commercial escrows. It is used to describe what is happening to an existing deed of trust on property you are being asked to insure. Frequently, counsel for the borrower or seller, depending on whether you are being asked to insure a sale or a refinance, will state that you won't be repaying that loan but instead it will be defeased. What the heck are they talking about?

When a loan is defeased, it is still outstanding but secured by a basket of government securities (usually bonds and/or treasury bills) instead of by the real property which was the original security for

the loan. Okay so far, but how do we get the loan off of our property and onto the government securities?

The mechanics of the closing work like this. The new loan for the sale of the property or to refinance the property will fund the purchase of the government securities. You will frequently be asked to send the loan funds to the securities intermediary BEFORE you are authorized to record a reconveyance of the deed of trust being defeased. The securities intermediary will purchase the government securities (which will be in amounts and durations that will throw off enough cash to make the payments on the loan being defeased). After the securities are purchased, the lender being defeased will instruct escrow and title to record the reconveyance of their deed of trust.

The risk here is the gap period between when escrow lets go of

the funds and when escrow and title are instructed to record the reconveyance. If there is a problem during this period, or the funds are misused by the securities intermediary, you will not be able to record the reconveyance and you will have a claim from your new lender because they will not be in first position.

DO NOT AGREE TO THESE TYPES OF ARRANGEMENTS UNLESS YOU HAVE APPROVAL FROM YOUR COUNSEL AND/OR MANAGEMENT, AS THE RISKS ARE EXTRAORDINARY.

Transactions involving loans that will be defeased are not for the inexperienced or the faint of heart and should only be done working closely with in house counsel or other personnel with sufficient experience and knowledge in this area. ■

The "ABCs of Title" Word Search

Words to Find:

- Access • Coverage • Easement
- Boundary • Deed of Trust • Forgery

F G P Q B O U N D A R Y K L D
 U O L B F K Z Q E J F R Y T O
 R P R L R O N J E M Q V S U M
 V P R G A Z S M D I H P S L L
 Y I C V E X Q I O L V W E W E
 P B O M S R O G F H I U C Y O
 N Z V F Y N Y L T Y T G C R V
 M I E R B A K T R M G D A P U
 K A R D J U P R U H Q X I R O
 J R A P G Y E A S E M E N T P
 J Q G N V W Y A T U B R C O Q
 P N E D R E I H F Q L P M D S

See Solution on Page 4

Watch for these future CLTA Publications...

April 2005

Claims Awareness Express

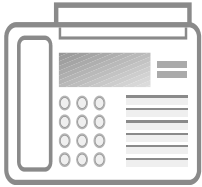
July 2005

Claims Awareness Hot Sheet

Archived Hot Sheet Articles

The CLTA's Claims Awareness Committee has compiled a **Claims Awareness & Prevention Compendium of Claims Awareness Hot Sheet Articles**. The book is over 200 pages that are indexed by topic and cross referenced to create a valuable training tool. To download a read-only copy go to: <http://www.clta.org/Publications/publications-index.htm>.

F A X



**“Sassy Cover
Sheets are
not
Privileged”**

To:
Fax number:

From: **Terry Title**
Fax number: **(555) 456-7890**

Date: **1/28/2005**

Regarding:

Comments:

**(please don't)
SUBPOENA THIS**

By: *Alicia Kamian, Esq.*
Old Republic Title Company

Escrow Edward had really had it with that annoying customer, Mr. Disturber, who was making yet another unreasonable demand. Edward wrote a note to his assistant asking her to accommodate that “dirty rotten &#*\$#&%, Mr. Disturber.” The note was for internal purposes – surely no one outside the Company would see it!

Title Terry was proud of her master fax cover sheet and how being so organized really saved her time. She even spiced it up with a clever, sarcastic comic strip boldly appearing next to the Company logo. It was just a bit of harmless fun. And, no harm done, because she only used that sheet for internal faxes – surely no one outside the Company would see it!

Before going on vacation, Escrow Elizabeth gave the Smith-Jones file to her manager with a desperate note begging the manager to closely watch the file while she was gone. The note said “Please do damage control . . . my associate has already been negligent, disbursed some funds willy-nilly without instructions, and told one party we like him best and are not really neutral. The file is a lawsuit waiting to happen.” The note was for internal purposes – surely no one outside the Company would see it!

Then, the inevitable happened: the Company was served with a Subpoena Duces Tecum for each file (that’s fancy Latin for “we can make you give us your documents”). The legal department reviewed the subpoenas and the files but could only withhold from production certain “privileged” documents. Unfortunately, the sassy fax cover sheets and the “internal” notes did not come within the attorney-client privilege or any other privilege. The unsavory documents became evidence in three trials.

At best, the courts and the parties to the lawsuits will view the Company with cynicism and a jaded eye. At worst, the Company has made admissions, exposing the Company to liability.

It is important to work efficiently and maintain good records in your files. You certainly should never omit or remove documents from your file out of fear of discovery. Always do what is appropriate in the ordinary course of business. But, please remember, almost nothing is private. Stick to the facts and enjoy the sassy stuff in the privacy of your thoughts.

**Editors'
Corner**



The *Hot Sheet* invites letters to the editors. Your letters can be about anything of interest concerning avoiding claims or related subjects. If you have an idea for an article, send it to us. We also invite you to submit articles for publication in future editions of the *Hot Sheet*. If you are hesitant to submit a complete article, send us a rough outline of your idea. The editors will write the article and you will be given credit for the idea.

EMERGING CLAIMS (cont.)

provided by Mr. Heinemann pursuant to the “power of attorney” from the beneficiary/lender which has been documented as noted above. This “substituted security” then purports to serve as the security for the repayment of the loan that underlies the original deed of trust. The “substitution and reconveyance” then follow.

Because these documents may be recorded in close proximity to the recording of a deed from the original owner, there may be an appearance of a lender- authorized substitution and reconveyance when looking at a computer printout. In instances in which a

substitution of trustee and reconveyance are in the chain of title within the past two years, this could lead to a belief that the reconveyance was made in the normal course of business.

These documents have reportedly been found from Alaska to the Carolinas, with the tally today of nearly two hundred identified instances. More will likely be uncovered with the passage of time. Instances have been identified in which title insurance has been issued in reliance upon these documents, leading to substantial claims against the policies by the insured lenders. ■

UPDATE: FBI RAIDED THE OFFICES OF HEINEMANN ON FEBRUARY 1, 2005

THE IMPORTANCE OF APPROPRIATE FILE MAINTENANCE

(Further Comment to “(Please Don’t) Subpoena This”)

By: *Emilie Fox, Claims Counsel*
Alliance Title Company

In the unfortunate event Company title and/or escrow files are subpoenaed, the subpoena and relevant files should immediately be turned over to your Legal Department or designated officer. As noted in the previous article, anything contained in the file that is not privileged and is not otherwise subject to withholding based on certain provisions of the law must be produced to the requesting party.

The file is subject to subpoena as it reflects the events of the transaction at or near the time they occurred. The person providing records in response to the subpoena, or “Custodian of Records,” must declare that the “accompanying records are true copies of the original records maintained in the regular course and scope of business of the Company. The accompanying records constitute all the records located that are responsive to [the Subpoena (Duces Tecum)] for Company records described as [escrow/title number].” The Custodian must also represent that the “the information in said records was entered in the ordinary course of business by person(s) having actual knowledge thereof at the time or soon thereafter of the events or incidents which they are intended to convey.”

Therefore, in order to ensure that the declaration is truthful, **you must not remove any documents**, redact any information, alter the file, manufacture documents, destroy or create any documents in the file. This applies even if the documents appear harmless and merely embarrassing to the Company (such as the internal e-mails with comments intended only for others within the Company and the “sassy” facsimile covers).

Your file should contain conversation logs of significant communications between Company personnel

and others regarding the file, including dates and times of the communication, with whom the communication took place, and the company, entity or party related to the person involved in the communication. Additionally, your facsimile cover sheets should contain all information relevant to the transmission, such as the person and company to whom the fax is directed, the documents being transmitted, and the fax number to which the documents were sent.

A good procedure to adopt is to view each file as though it is subject to review by third parties and/or the scrutiny of a court at some point in the future. This will help maintain a professional and complete record of the transaction, and may assist the Company with speedy resolution of problems or questions that may arise after the close of the file. ■

Solution:

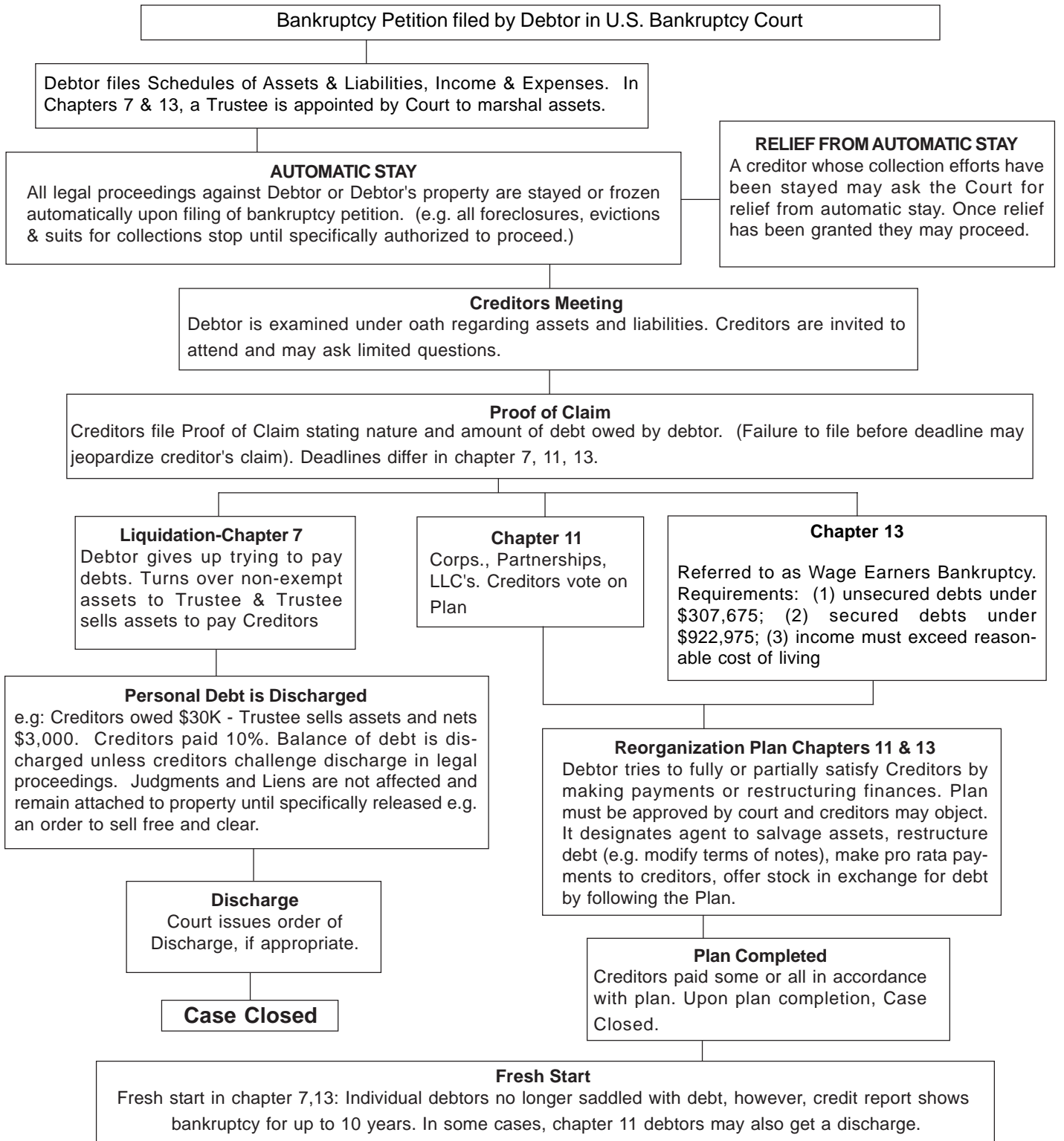
F G P Q B O U N D A R Y K L D
U O L B F K Z Q E J F R Y T O
R P R L R O N J E M Q V S U M
V P R G A Z S M D I H P S L L
Y I C V E X Q I O L V W E W E
P B O M S R O G F H I U C Y O
N Z V F Y N Y L T Y T G C R V
M I E R B A K T R M G D A P U
K A R D J U P R U H Q X I R O
J R A P G Y E A S E M E N T P
J Q G N V W Y A T U B R C O Q
P N E D R E I H F Q L P M D S

General Overview of Bankruptcy ---- Chapter 7, 11, and 13

by David A. Tilem, Esq. Los Angeles, CA

Bankruptcy specialist certified by State Bar of CA, Board of Legal Specialization

And Gary Bregman, Esq. Vice President Old Republic Title Company



General Notes:

1. Creditors or Partners can file an involuntary petition asking the Court to place the Debtor in bankruptcy against his/her /its will.
2. Any sale or financing or real property is subject to the approval of the Bankruptcy Court.
3. Warning: Bankruptcy is serious business and complicated. This chart is intended as a general overview of the process. Consult competent legal counsel, accounting and other financial professionals who specialize in bankruptcy work. There may be other less drastic alternatives than filing for bankruptcy.

Escrow 101: Follow the Instructions

(Letter Stating That “Payoff Funds” Were Received Did Not Constitute a Payoff Demand and Did Not Justify Premature Closing)

By: Mark D. Epstein, Esq.
Alborg, Veiluva & Epstein, LLP

It has long been established under California law that an escrow holder is a dual agent, who owes duties to each party to perform and comply *strictly* with every term and condition of the escrow instructions. A recent decision by the California Court of Appeal not only re-emphasizes the escrow agent’s duty to follow the parties’ instructions, but illustrates what the consequences can be when the agent fails to do so with respect to a loan payoff.

In *California National Bank v. Havis*, 120 Cal.App.4th 1122 (July, 2004), the California Court of Appeal reviewed an interesting, if not atypical, payoff dispute involving a \$1.2 million loan secured by a first deed of trust on a parcel of developed commercial property (a restaurant) in Beverly Hills. In June 2002, the owner of the property agreed to sell the property to Investor’s Capital Management Group, Inc. (“ICMG”) for \$2 million, and opened an escrow with Wilshire Escrow Company (“Wilshire Escrow”). ICMG obtained financing for the purchase from Gold Mountain Financial Institution, Inc. (“Gold Mountain”). Gold Mountain insisted that its loan be secured by a deed of trust with first priority and Gold Mountain’s escrow instructions provided that escrow was not to close if Wilshire Escrow became aware of any liens affecting the subject property which were not paid in full *through the escrow*, other than liens that Gold Mountain expressly agreed to.

A. The Buyer’s Purported Payoff of the Seller’s Loan Outside of Escrow

On June 20, 2002, the seller’s bank, which held the existing mortgage on the property, issued a payoff demand statement, and a copy was provided to Wilshire Escrow. The payoff demand statement provided a breakdown of all sums that were due and owing on the loan, totaling \$1,165,422.86. The statement also showed the per diem interest that would accrue on the loan balance, as required by California Civil Code Section 2943(a)(5), and stated that the demand statement would expire within 30 days.

The parties’ escrow instructions provided that the existing loan was to be paid off through escrow with funds from the Gold Mountain loan. However, in a strange and unexplained twist of events, the purchaser (ICMG), rather than its lender (Gold Mountain), delivered a personal check directly to one of the bank’s branches in the

amount of \$1,175,247.14 on July 24, 2002. This check purported to be the buyer’s payment to satisfy the seller’s loan, but the check was delivered four days after the expiration of the 30-day period expressed in the payoff demand statement. Moreover, the check ultimately was dishonored due to insufficient funds.

B. The Bank’s Letter Advising That It Had “Received Payoff Funds”

On July 29, 2002, five days after the sellers’ bank received ICMG’s check, the bank faxed a letter to Wilshire Escrow advising that the bank had “received payoff funds” in the amount of \$1,175,247.14, and noting that it had received the payment *outside of escrow*. The letter went on to state that it was the bank’s policy to issue a reconveyance of the deed of trust 10 days after it received the check. The bank employee who sent that letter testified that during a telephone conversation with the escrow officer in charge at Wilshire Escrow on the day the letter was sent, he reiterated that the underlying note had not been satisfied since the check from ICMG had not yet cleared. The bank employee also testified that he told the escrow officer that the bank would not forward a reconveyance of the deed of trust until the check from ICMG was collected upon.

Gold Mountain learned about ICMG’s purported payoff of the seller’s loan on the same day (July 29, 2002), and faxed a letter to Wilshire Escrow that day in which it expressed concern and asked that the escrow officer confirm that Gold Mountain’s deed of trust would be in first position. The letter went on to state that Gold Mountain had no way to verify that the borrower (ICMG) in fact paid off the seller’s loan because it is normally the title company which handles loan payoffs.

C. Escrow Closed Prematurely

For reasons that were never explained, the escrow officer at Wilshire Escrow decided to close the transaction by recording Gold Mountain’s deed of trust and the grant deed conveying title to the property to ICMG on August 1, 2002, four days *before* the expiration of the 10-day period that the bank said in its July 29, 2002 letter, it would need to verify that the funds cleared. The escrow officer did so despite the anomaly of ICMG’s purported payoff of the loan outside of escrow, and despite the fact that the escrow officer never received

notice that the payoff funds had cleared. The escrow officer's decision to close escrow was all the more puzzling in light of his testimony that "[e]veryone was totally aghast at the prospect that the buyer was paying off this existing first trust deed loan, so everyone was on heightened alert."

D. The ICMG Payoff Check Bounced

The loan payoff check that ICMG tendered to the seller's bank on July 24, 2002 bounced. On August 5, 2002, the bank sent a letter to the seller entitled "Updated Demand for Payoff," which stated that the loan had *not* been paid off. The escrow officer at Wilshire Escrow testified that he saw the updated settlement demand statement and understood from it that ICMG's payoff check had not cleared. Six weeks later, on September 25, 2002, the bank sent another letter to the seller, informing him that the loan had not been satisfied, that his purported sale of the property to ICMG was void, and that if the bank did not receive funds by October 25, 2002, it would commence foreclosure proceedings.

On October 30, 2002, the seller's bank filed a lawsuit against Gold Mountain, the holder of the new note. Gold Mountain, in turn, filed a cross-complaint to quiet title to the property and to cancel the seller's bank's deed of trust.

E. The Letter From the Seller's Bank Advising of Its Receipt of "Payoff Funds" Did Not Invalidate Its Deed of Trust

Gold Mountain argued that the July 29, 2002 letter from the seller's bank, advising of its receipt of "payoff funds," was an update of the bank's June 20, 2002 payoff demand statement, which somehow deprived the bank of its rights and remedies under the deed of trust. Gold Mountain went on to argue that the bank's only recourse against the seller to collect on the debt at that point was to pursue an action as an unsecured creditor. The Los Angeles County Superior Court agreed with Gold Mountain, concluding that the bank's July 29, 2002 letter was tantamount to a payoff demand statement and that the escrow agent reasonably relied on the letter to close escrow.

The Court of Appeal reversed the trial court's decision and reinstated the bank's mortgage because the July 29, 2002 letter from the bank did not list the total obligation that was to be satisfied, nor did it provide a per diem interest rate for the next 30 days, as required by statute (California Civil Code Section 2943). Instead, the bank's letter merely provided a status report of the loan payoff transaction and addressed an unanticipated development that occurred outside of escrow, nothing

more. Therefore, neither the parties nor the escrow agent were justified in treating the letter as a payoff demand statement, or in interpreting it to mean that the loan had a zero balance.

F. Conclusion: The Escrow Agent Erred in Failing to Follow the Instructions

The *Havis* decision serves as yet another reminder of how important it is for escrow officers to ensure that they are strictly complying with the parties' instructions in every transaction. The decision also appears to stand for the broader proposition that a statement, letter, or any other writing which does not contain all of the information specified by California Civil Code Section 2943, does not meet the definition of a payoff demand statement and cannot be relied upon to establish the amount owing on the underlying obligation in a payoff transaction. If an escrow is closed based on information contained in a document that doesn't comply with Civil Code Section 2943, the buyer, new lender, escrow company, and title company all face the risk that the prior lender's deed of trust will remain intact. ■

Are you a chronic doodler? Is your desk blotter calendar covered with sketches instead of appointments? If so, we may have just the creative outlet for you.

The Hot Sheet is always looking for title- or escrow-related graphics and cartoons to spice up its content. If you have any brilliant (or just plain funny) material that you'd like to see in print, send it to us, along with your name, phone number, and address. If we decide to publish it, you will receive a \$10 Starbucks gift card!



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