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New Duties For Connecticut Mortgage Lenders

Responsibilities focus on supervision of settlement agents

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Legal compliance is becoming increasingly difficult for lenders. As if the requirements of the Real Estate Procedures Settlement Act reform were not enough to digest, the Connecticut Banking Commissioner recently issued an order with potentially far-reaching implications.

On Oct. 21, 2009, the commissioner issued a Temporary Order to Cease and Desist/Intent to Revoke Mortgage Lender License against Ideal Mortgage Bankers Ltd. The commissioner sought to revoke the lender's license for failure to supervise settlement agents because its borrowers received disbursements at variance with the HUD-1 settlement statements provided at their closings.

The commissioner determined that the discrepancy between the HUD-1 and the actual disbursements made by the settlement agents constituted a failure *by the lender* to perform an agreement with the borrowers in violation of Connecticut General Statutes § 36a-494 (a)(1)(D) and C.G.S. § 36a-494 (b).

Furthermore, the lender's failure to implement internal controls necessary to ensure the settlement agents' disbursements in accordance with the HUD-1 forms demonstrated a lack of "financial responsibility, character and general fitness" in violation of C.G.S. §36a-489. Taken together, this conduct was such that the commissioner sought to revoke the lender's license.

Broadly speaking, the order against Ideal Mortgage Bankers seems to impose two new burdens on Connecticut lenders: First, lenders may be held strictly liable for changes in the amounts of disbursements between the closing and the funding under the commissioner's interpretation of § 36a-494.

Second, the commissioner determined that § 36a-489 imposes on lenders a duty to supervise settlement agents to ensure that they fund transactions in accordance with the HUD-1 provided at closing. This article will consider the lender's duty to supervise settlement agents.

Zero Cash Differential

What exactly must the lender supervise to be in compliance with C.G.S. §36a-489? Three specific duties may be inferred directly from the commissioner's order and a fourth may arise from litigation currently pending in federal court. First, the order seems to require that lenders ensure that there is a zero cash differential between the HUD-1 and the disbursement.

If the borrower expected cash back from the transaction, that amount must match the HUD-1. If the borrower needed to contribute funds to close, the lender must ensure that the amount needed does not increase post-closing. This duty to maintain the cash position follows from the section in the order where the commissioner required Ideal Mortgage to reimburse each borrower the amount necessary to put the borrower in the same position as if the borrower had received the funds in accordance with the HUD-1.

The second requirement seems to be a duty to ensure that the settlement agent disburses as scheduled. The commissioner's order indicates that Ideal Mortgage complied with the requirements of C.G.S. §36a-758, which requires lenders to deliver funds to the settlement agent by the day scheduled for disbursement. After delivery of the funds, however, the lender must go further and ensure that the settlement agent disburses promptly. The commissioner required Ideal to provide copies of all checks and wire confirmations from its closings and faulted Ideal for failing to have internal controls in place to determine whether the settlement agents funded as scheduled.


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The third duty is to ensure that the items affecting the borrower's credit are, in fact, paid off in time to maintain the borrowers' credit scores. The order required Ideal to take steps necessary to restore the borrowers' credit scores to the levels they would have been at but for the delayed disbursements. Furthermore, the commissioner requested copies of the backs of all disbursement checks. Presumably the lender must ensure not only that the settlement agent cuts the checks on the day scheduled for disbursement, but also that the checks are in fact delivered and honored by the settlement agent's bank.

Disbursing Funds

Finally, a lender may have a duty to ensure that the settlement agent is authorized to do business in Connecticut and is operating in compliance with Connecticut law. Unlike most other states, Connecticut has neither title nor escrow agent licensing. Connecticut law is not entirely clear on the issue of who is authorized to disburse funds, but several

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statutes shed light on the question.

First, the disbursement of settlement funds in itself is not the practice of law. (See §2-44a (5) of the Connecticut Practice Book.) Second, with the exception of individuals who held a valid title agent license prior to June 12, 1984, only Connecticut attorneys can be title agents. (See C.G.S. §38a-402 (13)). In some contexts the law authorizes specific persons to hold earnest money deposits, (in Connecticut escrow accounts), namely: licensed title insurance companies, attorneys, licensed real estate brokers or independent bonded escrow companies. (See C.G.S. §47-271). Thus, at a minimum, a lender must ensure that its settlement agent is either a licensed title insurance company, a title agent who complies with C.G.S. §38a-402 (13), an attorney, or an independent bonded escrow company, all of whom must maintain an escrow account in Connecticut that is designated as an IOTA or an IOTLA account.

Whether a lender can disburse to an independent escrow company is at issue, at least tangentially, in the pending class action case *Gale v. Chicago Title Insurance Co.,* District of Connecticut (2006). In *Gale,* the plaintiffs allege that title insurers cannot provide closing protection coverage to persons who are not title agents. Their reasoning is as follows: C.G.S. §38a-402 (13) restricts those persons who can be title agents to commissioners of the Superior Court (i.e. Connecticut attorneys) or individuals who held a valid title agent license prior to June 12, 1984. C.G.S. §38a-45 makes title insurance a mono-line business (i.e. title insurers cannot offer any other type of insurance). C.G.S. §38a-404 provides a carve-out to this mono-line restriction in that it authorizes underwriters to guarantee the obligations of their "agents."

Since only attorneys or grandfathered individuals can be title agents, the *Gale* plaintiffs argue that underwriters cannot provide closing protection coverage to escrow companies.

Closing protection letters provide an additional level of coverage not provided by the standard title insurance policy. See *Capital Mortgage Associates, LLC v. Hulton,* 2009 Conn. Super. LEXIS 380 (2009). That coverage protects a lender from defalcations by the settlement agent and from the settlement agent's failure to comply with the lender's closing instructions.

With the new liability the banking commissioner has imposed under §36a-489 and §36a-494, this coverage is more valuable than ever. If, however, the lender utilizes the services of an escrow company, the underwriter may be legally prohibited from extending closing protection coverage. Borrowers arguably are third party beneficiaries of closing protection letters. Thus the use of such unauthorized settlement agents could be viewed by the banking commissioner as a demonstration of a lack of financial responsibility, character, reputation, integrity and general fitness required by §489.

At a minimum, lenders using the services of escrow companies must ensure that those companies are bonded in accordance with §47-271. Furthermore, they should be suspicious of such companies who purport to be title agents under §38a-402 (13). Any closing protection letter which purports to provide coverage on behalf of an escrow company should be verified with the title underwriter, as it may be unauthorized, or if authorized, may be in violation of §38a-404.

Conclusion

The banking commissioner's order against Ideal Mortgage Bankers raises significant concerns for lenders doing business in Connecticut. The order interprets C.G.S. §36a-494 as imposing at least three duties on lenders to supervise settlement agents. First, a lender must ensure a zero cash differential between the HUD-1 and the disbursement. Second, the lender must guarantee prompt disbursement by the settlement agent, and third, lenders must ensure that items that affect the borrowers' credit are in fact paid off. Finally, based on the Connecticut laws related to title agents and closing protection letters, lenders should be certain that the settlement agent is authorized to conduct settlements under state law. If a lender requires closing protection coverage, it should only authorize the use of attorney title agents for its closings. ■