Three Title Insurance Traps for Real Estate Lawyers

Closing protection letters, the Form DS-1 disclosure, and the 2010 revisions to the Rules of Professional Conduct all present potential traps for real estate lawyers. Here's an analysis of the risks and how to reduce them.

By Michael J. Rooney

There are ethical pitfalls in all areas of practice. When it comes to title insurance, three are particularly dangerous.

First, real estate lawyers must know how to warn clients of the scenarios under which closing protection letters don't provide much protection. Second, they must know when they're required to complete the Form DS-1 disclosure of a "controlled business arrangement" by a "Producer of Title Insurance Business or Associate thereof" – and how to make sense of the form when their clients receive it. Finally, they must understand and comply with the informed consent and related provisions of the latest revision of the Rules of Professional Conduct. This article takes a look at all three issues.

When closing protection letters fail to protect

The adoption of PA 96-1454, effective January 1, 2011, requires closing protection letters (CPLs) for all residential real property transactions and for nonresidential transactions where the amount on deposit with the escrow agent is less than $2 million.[1] The letters are designed to protect parties from loss suffered when a title insurance agent improperly closed a transaction or mishandled funds and the title insurance company denied any responsibility for the title agent acting as escrow agent.[2]

1. See 215 ILCS 155/16 and 155/16.1.
2. The typical agency contract between the title insurance company and the title insurance agent provides that the agent is a limited agent only and its authority extends only to the issuance of title insurance commitments, policies, and endorsements. Such contracts also specifically note that the agent acts on its own behalf, not on behalf of the title insurance company, when it serves as an escrow agent (defined in 215 ILCS 155/3(8)).

The CPL must cover the buyer/borrower, the lender, *and* the seller of real estate in a covered transaction and must be issued by the title insurance company and not the title insurance agent.[3] In the absence of an agreement to the contrary between a title insurance company and a protected person, the matters against which the CPL must indemnify the protected person are also specifically included in the statute.[4]

Real estate practitioners, however, should not assume that all clients are fully protected simply because a title insurance company properly issues a CPL to the client in a covered transaction. In fact, there are at least three scenarios in which the recipient of a CPL is still at risk for the failure of the title insurance agent to perform its obligations and duties properly.

When title insurer goes out of business. The title insurance company that issued the CPL might go out of business, leaving recipients of its CPLs at risk. In 2008, The Guaranty Title & Trust Company, an Ohio-domiciled title insurance company licensed to do business in Illinois, was liquidated by the Ohio Insurance Liquidator.[5] The law of Ohio permitted the liquidator to cancel all the policies issued by GT&T. Insureds were notified and instructed to obtain replacement policies from competitors, then submit claims in the Ohio liquidation proceeding for the cost of the policies.

Needless to say, all CPLs were also cancelled and no new title insurance company would have been willing to issue a CPL to cover an agent for a closing conducted years before, especially when the agent in question might not have been an agent for the new title insurance company. Practitioners should always consider the financial strength and stability of the title insurance company that issues the CPL.

When agent's failure does not affect title to real estate or the priority of a mortgage lien. According to the statute the CPL's obligation to indemnify becomes effective only if the failure to follow written closing instructions or failure to obtain documents both relate to the status of title to the real estate or to the validity, enforceability, and priority of the lien of a mortgage on an interest in real property.

That means if a written closing instruction requires the escrow agent to pay off a credit card debt or other personal debt or obligation that does not affect title to the real estate, the title insurance company is not obligated to indemnify the recipient of the CPL for loss caused by the title insurance agent's failure to follow the closing instruction.

Similarly, if the escrow agent is required to obtain a document – say, a letter stating that the credit card debt or other personal obligation has been paid – but fails to do so because the required payment is not made, the title insurance company is not obligated under the CPL to indemnify the protected person. Again, the failure does not relate to the status of title to the real estate or to the validity, enforceability, or priority of the lien of the mortgage on the real estate.

When an agent improperly handles possession or repair escrow. Third, and based on the same reasoning, the title insurance company is not responsible under the CPL to indemnify the protected party where the escrow agent fails to properly handle a possession or repair escrow. Again, such matters do not affect the status of title to the real estate or the validity, enforceability, or priority of the lien of a mortgage on real estate.

Thus, if the agent absconds with all the escrow funds, the practitioner's client is not protected by the CPL, even if the CPL is required because the transaction is a covered transaction and even where the title insurance company properly issues (and is paid for) the CPL.

Understanding the Form DS-1 disclosure

Real estate practitioners must know when they are required to complete the Form DS-1[6] disclosure or a "controlled business arrangement" by a "Producer of Title Insurance Business or Associate thereof" and give it to principals in a real estate transaction. They must also know how to analyze the form when their clients receive it. The Form DS-1 is only required in transactions involving residential property as defined in the statute,[7] not for nonresidential real property.

The form must be used by a "producer of title business" with a financial interest in either the title insurance company or agent to whom the producer has referred an "applicant."[8] A "producer of title business" is a person or entity engaged in the business in Illinois of buying or selling real estate, making loans secured by real estate, or acting as a broker, agent, attorney or representative of persons or entities that do so.[9] "Financial interest" is defined as any ownership interest, legal or beneficial, but does not include the ownership of publicly traded stock.[10]

Many attorneys believe the Form DS-1 disclosure satisfies RPC requirements, but that is clearly not the case for a number of reasons.

The form must be given and the required disclosures made to any party paying for the products or services, or to that party's representative. Where one side pays all title and closing costs, presumably Form DS-1 need only be given to that party.

One attorney required to use Form DS-1 argued that he gave the form to himself and had thereby made the required disclosure to his client. His rationale was that he held a valid power of attorney from the client, which made him the client's "representative" to whom disclosure could be made. The ARDC Review Board rejected that position and the attorney was suspended for six months.[11]

3. 215 ILCS 155/16(f).
4. 215 ILCS 155/16.1(b).
5. The DFI Notice of Liquidation, including case citations and deadlines, is found at http://www.idfpr.com/news/newsrls/11072008DFINoticeofLiqofGuarantyTitleTrustCo.asp.
6. Found at http://www.idfpr.com/DFI/TitleInsur/pdf/disclosure_statement.pdf.
7. 215 ILCS 155/18(a).
8. 215 ILCS 155/18(b).
9. 215 ILCS 155/3(4).
10. 215 ILCS 155/3(6).
11. *In re Andrew J. Rukavina*, No 07 CH 0096; MR 23585, available at https://www.iardc.org/rd_database/rulesdecisions.html.

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Estimate of charges. The statute requires that the disclosure include an estimate of charges for services as described in section 19,[12] which include issuing title insurance policies (including service or administrative fees, abstracting, searching, and title examination charges); preparing and issuing preliminary reports, property profiles, commitments, binders or like products; closing or escrow fees; settlement fees; or like charges. Interestingly, the Form DS-1 itself contains only four lines, identified as "Owner's Title Policy," "Mortgage Title Policy," "Escrow or Closing Fee," and "Other Fees," plus a line for the total of those charges.

Title search, examination costs. Assume the producer of title business with a financial interest in either the title insurance company or agent includes the cost of the title search and title examination in the price for the two policies. Does that meet Form DS-1's requirements? Or must sections 18 and 19 be read together, in which case only a complete list of every charge listed separately in Section 19 would suffice?

It's the former, not the latter. Form DS-1 has an asterisk for both the "Owner's Title Policy" and "Mortgage Title Policy," together with a recitation indicating that the charges for those two policies include any search, examination, and policy premium charges. A separate listing is not required.

Timing of disclosure. Section 18(b) requires that the Form DS-1 disclosure be made before the commitment for title insurance is issued, although the bill's sponsor said on the record before the vote that a disclosure given contemporaneously with issuance satisfies the "prior to the time the commitment is issued" requirement.[13] A disclosure made later than that does not permit the parties to select another title insurance provider if they so choose.

The lawyer's personal interest as title insurance agent could materially limit his or her representation of the client and thus should be disclosed.

In practice, however, the lawyer may not even meet the client until closing, and many lawyers send the Form DS-1 with the title insurance commitment. That satisfies the intent, if not the letter, of the law.

Signature requirement. The Illinois Title Insurance Act itself is silent about a requirement that the Form DS-1 be signed by the recipients. However, the form available on the IDFPR website includes two signature lines each for the buyer and seller/owner. Given the vagaries of modern real estate practice, it is not uncommon for the attorney to send the Form DS-1 with the commitment for title insurance and have another copy signed by the parties at the closing. Without a signed form, it would be hard for a lawyer to prove except through testimony that disclosure was made.

"Financial interest" in publicly traded title companies. Thankfully, most, though not all,[14] attorneys acting as title agents understand the mandatory nature of the Form DS-1 disclosure. Unfortunately, many are not careful about how the form is completed, which can lead to problems.

For example, the form must be completed by producers of title business with a financial interest in the title insurance company. Most title insurance companies licensed to do business in Illinois[15] are either publicly traded or are wholly owned subsidiaries of large publicly traded entities.

In either situation, the producer of title business cannot possibly own a financial interest in the company, because the term "financial interest" does not include ownership of publicly traded stock, and thus the attorney cannot own a financial interest in the title insurance company.[16] What happens, then, when a producer of title business completes a Form DS-1 to indicate the attorney owns a financial interest in, say, Chicago Title Insurance Company? The statement cannot possibly be true. Does that make the Form DS-1 invalid or merely erroneous? The statute is silent on the issue.

The producer of title business must also disclose his or her financial interest in the title insurance agent. Thus, where the law firm is the registered agent, attorneys who own a financial interest in the firm must disclose it. Similarly, where an individual lawyer owns a corporation or LLC registered as a title insurance agent, that financial interest must be disclosed.

Improperly completed forms. What, then, is the obligation of counsel for a party who receives a form that has been improperly completed? In order to protect both the client and the lawyer, the best practice is to privately point out to the other lawyer the problems with the form and insist upon corrections.

A lawyer-producer who is registered individually as a title insurance agent should fill in his or her registered title agent name, despite the argument by some that one cannot own a financial interest in oneself. Clearly, the purpose of the form is to disclose the agent's financial benefit.[17] Thus, the producer of title business should put his or her name on the line where the agent's name goes. Unless the title insurance company is ATG and the lawyer is a stockholder, no title insurance company name should be placed on that line.

Ethics rules: conflict-of-interest disclosure requirements

The interplay between the disclosure requirements of Form DS-1 and the Rules of Professional Conduct (RPC)[18] is another source of peril for practitioners. Sadly, many attorneys believe the Form DS-1 disclosure satisfies RPC requirements, but that is clearly not the case for a number of reasons.

First, Form DS-1 is only required in residential transactions. No ethical rule

12. 215 ILCS 155/19.

13. See Transcript of House Proceedings on HB 1832 of May 25, 1989, at pages 52, 53, available at http://ilga.gov/house/transcripts/htrans86/HT052589.pdf.

14. See *In re Shaveda Monique Scott, ARDC Commission No 09-102*, where a hearing board report recommended a 60-day suspension for a lawyer who testified, along with her law partner, that neither of them were aware of the requirement to complete and distribute the Form DS-1 and where both of them thought the title insurance company that registered their firm as a title insurance agent should have told them about it. Further, Ms. Scott testified she did not believe anyone really used the form anyway! Ms. Scott is currently voluntarily inactive and not registered with ARDC and not authorized to practice law in Illinois.

15. The complete list can be found at http://www.idfpr.com/DFI/TitleInsur/TISearch.asp. Click on the button that says "Click here to perform Title Company Search" and all licensed title insurance companies will be shown.

16. Attorneys' Title Guaranty Fund, Inc., is a notable exception because its stock is *not* publicly traded and attorneys can and do own financial interests in the company.

17. Although Ms. Scott testified that the main purpose of the form was to advise the client what company was providing title insurance and where the closing was to take place!

18. Found at http://www.state.il.us/court/SupremeCourt/Rules/Art_VIII/ArtVIII_NEW.htm#1.8.

limits the attorney's duty of disclosure to residential transactions.

Second, Form DS-1 was designed and intended for use by *all* producers of title business with a financial interest in the title insurance company or title insurance agent. It was not designed or intended to be used solely by attorneys.

Third, the Form DS-1 is woefully incomplete in terms of the disclosures the RPC requires, especially in light of the version of the rules that took effect January 1, 2010.

Informed consent. The new rules introduce the concept of "informed consent,"[19] which "denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." But Form DS-1 does not contain any information about the risks of proceeding and says nothing about available alternatives. It does not contain enough information to satisfy the lawyer's obligation to make disclosure and to receive informed consent from the client.

Rule 1.7. Ethical disclosure (and the client's informed consent) is required by Rule 1.7 ("Conflict of Interest: Current Clients"), which provides as follows:

> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if: (1) the representation of one client will be directly adverse to another client; or (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
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> (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if: (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and (4) each affected client gives informed consent.

The lawyer's personal interest as title insurance agent could materially limit his or her representation of the client and thus should be disclosed. Some would argue that the risk must be significant before disclosure is required. But given the financial size of most real estate transactions and the consequent risk to the client and lawyer, disclosure should be the default. Failure to disclose could lead to an ARDC complaint.

Rule 1.8. Disclosure may also be required by Rule 1.8 ("Conflict of Interest: Current Clients: Specific Rules"), which governs business transactions with a client. Rule 1.8(a) provides as follows:

> A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to the client unless: (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client; (2) the client is informed in writing that the client may seek the advice of independent legal counsel on the transaction, and is given a reasonable opportunity to do so; and (3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction, including whether the lawyer is representing the client in the transaction.

Where it applies, the rule for the first time requires written disclosures *and* a written informed consent *signed by the client*.

Rule 1.8(a) clearly applies where the attorney owns a corporation or LLC registered as a title insurance agent and refers the client to that entity for title insurance.[20] On the other hand, I have argued that an attorney registered individually as a title insurance agent (or whose firm is so registered) and who provides title insurance to or on behalf of the client in a real estate transaction is providing a legal service (just like drafting a deed) and has not engaged in a business transaction with a client. If that's accurate, Rule 1.8(a) does not apply in that case.

However, in the same case it is clear that Rule 1.8(f) *does* apply. That rule provides as follows:

> (f) A lawyer shall not accept compensation for representing a client from one other than the client unless: (1) the client gives informed consent; (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and (3) information relating to the representation of a client is protected as required by Rule 1.6.

In other words, if providing title insurance is defined as a legal service, and if someone other than the client – for example, the other side to the real estate transaction – pays any portion of the title insurance premium the lawyer keeps, then Rule 1.8(f) must apply and the lawyer's ethical disclosure form must be comprehensive enough to address it, unless the lawyer uses an additional disclosure form for that purpose.

Know your obligations

As with any other area of law, real estate practice is not getting any simpler. Whether you serve as a title insurance agent or not, the issues discussed above present potential traps that can be navigated successfully with a little thought.

Be sure to advise a client receiving a CPL of the scenarios where risk is still present. Be sure that if you use the form DS-1 or receive it as counsel for the other side, you know what it should say and assure yourself and your client that's what it does say. And be sure to read, understand, and comply with the requirements of the RPC so you don't place your law license at risk. ■

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19. Rule 1.0 Terminology.

20. See, *In re Andrew J. Rukavina*, No 07 CH 0096; MR 23585, and *In re Andrew J. Rukavina,* No 10 CH 0099; MR 24818, available at https://www.iardc.org/rd_database/rulesdecisions.html.