CHAPTER

04 TITLE ISSUES AND CLOSING

Learning Objectives

After this chapter, you will be able to

→ Discuss the issues associated with closings where the seller of the property is an LLC or Trust.
→ Identify what types of documents and bank accounts should be in place for an LLC or Trust to appropriately obtain their proceeds from a sale.
→ Explain the ramifications of an unnotarized T-47 delivered at closing.
→ Identify the two reasons a listing agent should not switch title companies for the purpose of closing a backup or second contract.
→ Name one FIRPTA best practice an agent/broker should take with a seller.

Closing LLCs

The market has experienced a surge of investors buying residential property to renovate and flip. These investors often take title in the name of a limited liability company ("LLC").

LLCs are a popular entity structure for holding investment property because of the insulation from risk exposure and potential tax benefits, but also because of the perceived ease of administration. Investors can go online to file the Certificate of Formation with the Texas Secretary of State. Unfortunately, that is as far as many go. Many fail to create an operating agreement (also known as a company agreement) to establish the particular authority, or even the exact number, of the manager(s) or member(s). This results in situations where the title company can only rely on the Certificate of Formation's designation of manager(s) or member(s) and a written statement from such persons. Such a statement may be a certificate or affidavit stating that the only member(s) or manager(s) are those listed in the formation documents and that such persons have the authority to sign on behalf of the company for the contemplated transaction. But these affidavits are often self-serving, leaving title companies and the LLCs themselves open to greater risk of fraud or unauthorized persons conducting transactions on the LLC's behalf. In an effort to provide some relief, the legislature passed a bill this session that allows a third party to rely on an Affidavit of Authority to Transfer real property by an LLC or other covered entity (H.B. 1833). The Affidavit must contain all the information required in the statute and is restricted based on

the size of the transaction. Additionally, it is specific as to who can sign the Affidavit. The Affidavit is not in lieu of an operating agreement, but may be relied on by the title company. It is highly preferable for all involved to have an operating agreement in place.

In addition to these challenges, when an LLC sells property, title companies often find that the investors using the LLC structure to hold title to the property have never opened a bank account in the name of the LLC. Instead, the investors request the sales proceeds be paid to the individual member(s) of the LLC.

There are two problems with issuing the sales proceeds to an individual instead of the actual seller, the LLC. The first issue has to do with the fiduciary duty title companies owe to lenders. In Home Loan Corp. v. Texas American Title Co., 191 S.W.3d 728 (Tex. App.–Houston [14th Dist.] 2006, pet. denied), the court ruled that a title company owes a fiduciary duty to the lender to close according to the lender's closing instructions. Since that ruling, most lenders have inserted language in their closing instructions to the effect that the title company is not authorized to close the transaction if the title company is not prepared to complete and deliver the transaction as shown on the settlement statement. If the title company pays sales proceeds to an individual or entity who is not the "seller" reflected on the settlement statement, it violates its fiduciary duty to the lender.

However, even if the settlement statement were specifically to reflect a line item payment of seller's proceeds to an individual other than the LLC, a second issue remains regarding the purpose and protection of the LLC structure. An LLC can shield an individual from personal liability and set up a structure for writing off expenses for income tax purposes. However, the payment of the LLC's proceeds to an individual could support a potential claim that the LLC is a sham or a mere "alter ego" of the individual, thereby potentially subjecting the individual to liability and tax issues that the LLC was formed to protect against.

This is because Texas courts have held that an LLC member may be held individually liable for debts of an LLC if the LLC is a mere alter ego of the member. An alter ego may be found when the LLC and individual are so unified that holding only the LLC liable would work an injustice. One of the factors used by courts in determining whether such unity exists is the degree to which individual property has been kept separately and has not been commingled with LLC property. See, e.g., Watkins v. Basurto, 2011 WL 1414135 (Tex.App.–Houston [14th Dist.] Apr. 14, 2011, no pet.); Doyle v. Kontemporary Builders, Inc., 370 S.W.3d 448 (Tex.App.–Dallas 2012, pet. denied); and In re Arnette (Ward Family Foundation v.Arnette), 2011 WL 2292314 (Bankr. N.D. Tex. June 7, 2011).

Therefore, the failure to maintain a bank account for the LLC and commingling its real estate proceeds with individual funds can bolster the position of creditors and other organizations wishing to "pierce the corporate veil" to reach beyond the LLC to the individual's assets. It is in the best interest of the title company, the LLC, and its members that the LLC's proceeds be disbursed into an account in the name of the LLC.

Closing Trusts

Many homeowners have placed their homes in trust to avoid probate. However, similar to the LLC issues discussed above, because the home is often the only asset in the trust, the homeowners never set up a bank account for the trust. Upon closing, the trustee of the trust asks the title agent to pay the proceeds directly to the individuals (trustees and/or beneficiaries of the trust). For the same reasons as above, paying an individual that is not the official seller in the transaction is problematic and can subject the title company to liability.

When listing a property held in the name of a trust or LLC, real estate agents can do a great service to their clients by reminding them that the title company will be required to pay proceeds to a bank account in the name of the LLC or trust. This allows them time to provide the necessary paperwork required by the bank and avoids closing delays occasioned when sellers must wait for the activation of a new bank account to receive proceeds.

Commission Disbursement Authorizations and Instructions

Many real estate brokers ask the title agent to split the commissions up between the broker and agents. This is done by written authorization from the broker, which is commonly referred to as a Commission Disbursement Authorization ("CDA"). Under the Real Estate License Act (Chapter 1101 of the Texas Occupations Code), which governs brokers and sales agents, brokers may only pay commission to license holders.

Specifically, Texas Occupations Code Section 1101.651 states:

> "A licensed broker may not pay a commission to or otherwise compensate a person directly or indirectly for performing an act of a broker unless the person is:
> (1) A license holder; or
> (2) A real estate broker licensed in another state who does not conduct in this state any of the negotiations for which the commission or other compensation is paid . . . ."

A common challenge comes when a license holder has been advised to set up an LLC through which to run his or her real estate activity for tax purposes. The title company receives a CDA from the broker directing a specific portion of the commission to be paid to the license holder. The license holder then asks the title company to pay such commission portion to his/her LLC. But, unless the LLC itself is licensed, the commission cannot be paid to the LLC. Paying the LLC in this situation would:

i) cause the title company to violate the instructions provided in the broker's CDA;
ii) subject the broker to penalties and fines imposed by the Texas Real Estate Commission ("TREC") for paying commission to a non-licensed person or entity [a violation of TREC Rule §535.147]; and
iii) potentially create an IRS audit issue because the 1099 issued by the broker to the license holder would not match the license holder's tax return.

Unless the license holder gets his or her LLC formally licensed with TREC, the license holder should not ask the title company to pay the license holder's commission to the LLC.

T-47 Misconceptions

Some real estate agents pay little attention to the importance of having the T-47 notarized and executed by all sellers listed on the contract within the timeframe specified in the contract.

Paragraph 6(c)(1) of the TREC One to Four Family Residential Contract (Resale) (the "Contract") states, "Within ___ days after the Effective Date of this contract, Seller shall furnish to Buyer and Title Company Seller's existing survey of the Property and a Residential Real Property Affidavit (T-47 Affidavit). If Seller fails to furnish the existing survey or affidavit within the time prescribed, Buyer shall obtain a new survey at Seller's expense . . . ." (emphasis added).

Listing agents often assume that their clients can comply with the above paragraph by delivering an unnotarized T-47, which could then just be resigned and formally notarized at closing. However, the Contract specifically requires that Seller deliver an "affidavit." By definition, an affidavit is a sworn statement. A statement that is not sworn cannot be an affidavit and, therefore, if the T-47 does not contain the sworn notarization contemplated by the promulgated form within the time specified, the Seller has not "furnished" the affidavit in accordance with the Contract. The ramifications of this failure, as stated in the Contract, are that the Buyer can then obtain a new survey at Seller's expense.

Additionally, a title company can rely on a T-47 affidavit signed by only one of two or more individuals named as the "Seller" in order to approve the survey. However, if the T-47 affidavit is not signed by all individuals who are listed as "Seller" in the Contract, then the "Seller," as that term is defined, arguably did not provide the required affidavit. Again, under the consequences outlined in Para. 6(c)(1) of the Contract, Buyer would be able to obtain a new survey at Seller's expense.

Back-Up and Second Contracts

After a contract "falls through" or otherwise appears as if it will not close, sellers often jump to sign a new contract with a new buyer, even though the first contract has not been formally released by all parties. Often, the new buyer signs a contract, pays the option fee, deposits the earnest money, and incurs other expenses before learning that the seller cannot close because the first contract was not properly terminated and remains in dispute. It is thus prudent for buyer's agent to ask for evidence that all parties have been fully released from their obligations under the first contract before entering into a contract with seller.

If the first contract has not been fully released, the second buyer may be better off entering into a back-up contract with seller. The TREC Addendum for Back-up Contract still requires that the option fee be paid and earnest money be deposited in accordance with the contract, but it defers the time for performance of all other obligations under the contract until the first contract is terminated and the backup becomes "primary." If the option fee is properly paid, buyer's unrestricted right to terminate begins immediately and, after becoming primary, extends for the number of days stated in Paragraph 23 of the contract (assuming use of a standard TREC contract). This gives the buyer the option to wait until becoming primary to spend any money on inspections, and it keeps seller from being in default if the first contract is not terminated by a specific time.

Listing agents, knowing that the title company cannot and will not close a second contract on the property until the first one has been fully released, may switch the title company for the closing of the second contact.

This is a mistake for two reasons:

i) if the second buyer knows that the first contract has not been fully terminated and released, and the first buyer later makes a claim under the first contract, the second buyer has no protection under the title insurance policy. This is because the owner's title policy excludes coverage for matters that are known to the insured, but not the title company, on the date of the

policy, unless such matters appear in the public records; and

ii) if the second buyer does NOT know about the first contract, the second buyer may have protection under the title policy; however, as with any insurance contract, the title company (insurer) is subrogated to the rights of the buyer (the insured) to go after the party at fault. At closing, the seller signs a "warranty deed" to the buyer. The warranty deed "warrants" that title is free and clear of encumbrances (except as otherwise stated therein). When the seller does not disclose the pre-existing first contract, the title company can step into the shoes of the buyer and pursue the seller under the warranty deed. Thus, a real estate agent that encourages opening the second contract with a second title company for the sole purpose of closing without regard to the unreleased first contract is not only doing a disservice to his or her clients, but could be found by TREC to be acting negligently or in bad faith.

Escrow Requests to Avoid

There are several requests title company escrow officers receive from real estate agents that should be avoided. Below are some common examples.

1. Real estate agents should not ask the escrow officer to select or order the buyer's residential service contract.

   The buyer, and not the escrow officer, should handle the process of ordering a residential service contract ("RSC"), also known as a "home warranty." The buyer can send the invoice to the escrow officer to be collected and paid at closing. The escrow officer has limited or no familiarity with the structure, features, or size of the home subject to the RSC, and the escrow officer is unaware of the particular coverages the buyer may want included in the RSC's coverage. Real estate agents do a disservice to their clients if they do not encourage them to be involved in this process. Title companies and real estate agents can end up in conflict with the buyer after closing if the buyer is not involved in selecting the RSC coverages, and then buyer ends up having to pay for repairs for which RSC coverage was available but not selected.

2. Real estate agents should not ask the escrow officer to pass checks between buyer and seller at closing.

   Sometimes real estate agents ask that the title company deliver a check from buyer to seller, or vice versa, at closing for funds that are not shown on the settlement statement (often referred to as the "Closing Disclosure"). However, in any transaction where the buyer has a lender, any monies that need to be transferred between Seller and Buyer at closing must be reflected on the Closing Disclosure. The title company has a fiduciary relationship with the lender, which requires the title company to close as instructed on lender's written closing instructions. Typical lender closing instructions contain language similar to the following:

   "The escrow agent shall close the transaction and disburse funds only in accordance with the Closing Disclosure. If any party to the transaction requests that his/her funds be disbursed in any manner different from the Closing Disclosure, the escrow agent shall advise us of the request and obtain prior approval from us before any funds are disbursed in a manner different from the Closing Disclosure."

   This means that payments for matters connected with the sale of the property, such as leasebacks, non-realty items, or credits from Seller to Buyer, must be reflected on the Closing Disclosure. To ask the escrow officer to aid them in circumventing the Closing Disclosure via "side payments" not reflected thereon is to ask the title company to violate its fiduciary duty to the lender. In addition, "side deals" not reflected on the Closing Disclosure could also subject those involved to liability for mortgage fraud.

3. Real estate agents should not ask the escrow officer to delay closing due to a dispute between the listing agent and the buyer's agent as to the commission split.

   Technically all of the commission belongs to the listing broker. In the event of a dispute, the law would require the title company to pay the listing broker all of the commission, and the buyer's broker would have to pursue the listing broker for their split owed to them. To try to hold up a closing based on such a dispute is a violation of the agent's fiduciary duty to act in the best interest of the client.

4. Real estate agents should not ask the escrow officer to notarize pre-signed documents.

   With the exception of Online Notaries (who are subject to a separate set of stringent regulations), a Texas notary cannot notarize the signatures of persons that do not sign or acknowledge a document in the notary's physical presence. Texas notaries must also review sufficient identification that meets the standards required by state notary

regulations. Asking a notary to notarize documents of a client who is not present is asking the notary to break the law.

5. Real estate agents should not ask the escrow officer to pay an entity (LLC's) or trust seller's proceeds directly to an individual client.

   See the above section on Closing LLCs.

6. Real estate agents should not ask escrow officers to pay their individual agent commissions to their own unlicensed LLCs.

   See the above section on Closing LLCs.

7. Real estate agents should not be delivering option fee monies to title companies instead of the listing agent or sellers.

   See the above section on Closing LLCs.

FIRPTA Best Practices

The day of closing is NOT a good day to learn that the seller is a foreign person.

This is not something to ignore and assume title or someone else is going to take care of FIRPTA.

A commonly used listing agreement under "other notices" has a paragraph regarding "foreign status". On every listing appointment, there is an action that each seller should take to answer the question regarding their foreign status or not foreign status. A prudent broker will have a list of CPAs or attorneys who are familiar with FIRPTA to provide to a seller with a foreign status. The CPA or attorney can guide the seller and advise them regarding their tax obligations under this law. A license holder should NOT take it upon themselves to determine whether or not the seller has a tax obligation under FIRPTA. However, it will be important for the buyer of any property of a foreign status seller to know this has been taken care of in advance of the closing date, since the law requires the buyer to withhold from the sales proceeds an amount sufficient to comply with applicable tax law and deliver the same to the IRS.

It is not the title company's job to take care of these issues for the seller or the buyer.

TREC Promulgated Contracts

20. FEDERAL TAX REQUIREMENTS: If Seller is a "foreign person," as defined by Internal Revenue Code and its regulations, or if Seller fails to deliver an affidavit or a certificate of non-foreign status to Buyer that Seller is not a "foreign person," then Buyer shall withhold from the sales proceeds an amount sufficient to comply with applicable tax law and deliver the same to the Internal Revenue Service together with appropriate tax forms. Internal Revenue Service regulations require filing written reports if currency in excess of specified amounts is received in the transaction.