



Basics of Hard-money Escrows: More Important Than You Think

Part I

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Escrow probably is one of the most underappreciated parts of the hard-money business. This mindset is dangerous because escrow can make or break any deal and every properly structured real estate transaction requires an escrow to close.

This series of articles on escrow will cover escrow basics, choosing an escrow company and an escrow officer, escrow processes and procedures and escrow mistakes to avoid. This article focuses on escrow basics.

The simple order of opening an escrow initiates a complex and often-misunderstood key component of any funding. Poorly structured escrows, inexperienced escrow officers or ignoring details put at risk all parties in escrow — i.e., lenders, sellers, buyers, borrowers and brokers — as well as the hard-money deal itself. Officers must possess an impressive knowledge of details that can save escrow parties time and money, as well as their reputation and more.

Escrows can be opened for any transaction, such as cars, boats, diamonds, monetary disputes and more — not just those related to real estate. Parties should open an escrow any time an independent, regulated third party is needed to ensure that specific instructions are followed before closing a deal. State agencies regulate escrow companies that operate within them. Most companies maintain errors-and-omissions insurance, which can comfort the escrow parties. If an officer or company makes an error, injured parties can submit a claim, ideally to

cover any potential losses.

There are six main roles of escrow:

1. Obtain instructions from all parties.
2. Draw transfer documents.
3. Obtain title insurance.
4. Collect funds.
5. Record the documents with the county recorder.
6. Disburse funds and send executed documents to the escrow parties.

Escrow starts with the instructions. All escrow parties must agree to and sign the instructions generated by the parties to the escrow officer. These instructions are addressed to a third party (i.e., the officer) who has agreed to be a stakeholder in the transaction. The escrow parties also need to sign the officer-generated instructions. Signing these two sets of instructions creates a binding contract between the parties to perform their agreed-upon responsibilities related to the transaction. Having this in writing is a critical component to each escrow. Escrow officers follow these legal and executable instructions, which can ensure all escrow parties protection from unilateral changes to escrow instructions, unless acceptable changes are clearly delineated in the signed instructions given to escrow.

An escrow has only one name, but it can come in different types with different responsibilities for escrow officers. Some escrows chosen for real estate transactions are simple “pass through” escrows. In hard-money circles, this type of escrow sometimes is called a sub-escrow. Essentially, this



means that funds are deposited into an escrow account and then dispersed from the account based on instructions from escrow parties. This type of escrow limits the escrow officer's role to accepting and disbursing funds as per instructions and possibly recording of any documents. The benefit of this type of escrow is that it can be opened and closed within the same day, and the cost also is lower than a more-involved escrow. Drawbacks are that the escrow parties do not get a closing statement and take a higher level of risk for errors and omissions because the officer's role is so limited. However, the parties to escrow can customize the officer's role to add responsibilities.

Another escrow, sometimes called a full escrow in hard-money circles, involves the officer more. This type is used almost universally in residential real estate transactions funded by institutional lenders. In addition to the responsibilities for a sub-escrow, the escrow officer's duties also potentially include ordering payoff demands, generating a closing statement, rectifying title issues, ensuring proper recording of all documents and more. The officer's more-active role is a benefit because it ensures that all the necessary components of a complex transaction are executed properly and backed by

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the company's errors-and-omissions insurance. Additionally, a closing statement is generated and sent to all escrow parties. A drawback is that a full escrow requires time to close, typically a minimum of two weeks because of the amount of time required to obtain information from third parties (i.e., bank payoff demands, etc.). It also is more expensive because of the time and effort required from the escrow officer.

“The simple order of opening an escrow initiates a complex and often-misunderstood key component of any funding.”

My next escrow article will address the process of selecting a reputable and competent escrow company and officer for hard-money transactions. Good luck.

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