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THE TWENTY-FIFTH STATE LEGISLATURE
REGULAR SESSION OF 2009

Monday, March 16, 2009
2:00 p.m.

TESTIMONY ON S.B. NO. 887, S.D. 1 - RELATING TO ESCROW DEPOSITORIES

THE HONORABLE ROBERT N. HERKES, CHAIR,
THE HONORABLEJON RIKI KARAMATSU, CHAIR,
AND MEMBERS OF THE COMMITTEES:

My name is Nick Griffin, Commissioner of Financial Institutions ("Commissioner"), testifying on behalf of the Department of Commerce and Consumer Affairs ("Department"). With the necessary amendments that I am requesting today, the Department strongly supports this Administration bill relating to escrow depositories.

The purpose of the bill is to amend and update Hawaii Revised Statutes ("HRS") chapter 449, the law that governs the licensing and regulation of Escrow Depositories. The Department has been advocating reform of this statue since 2004 to reflect

developments in the way the industry operates and the growth in the size of transactions which are routinely handled by Hawaii's escrow depositories, many of which are arguably undercapitalized. Hawaii's consumers are not adequately protected by the existing statute, which has not been updated in 36 years as to minimum capital requirements. The current statute is also outdated in many other aspects, and does not provide either consumers or escrow depositories with a contemporary framework to conduct escrow transactions.

At a minimum, certain revisions to the escrow depository law are critical to clarify which escrow transactions are covered by the statute and which are not; to update the statute in order to accommodate the significantly larger transactions routinely handled by the industry; to provide for more flexibility in supervising and regulating the industry; and to ensure adequate protection for the consumer.

In response to testimony opposing Senate Bill No. 887 that was recently submitted by the Hawaii Escrow Association ("HEA") to the Senate Committee on Commerce and Consumer Protection, I wish to provide your committee with the following comments:

1. In light of the enactment, in 2006, of chapter 487N, HRS, relating to protection of individuals from security breaches, the definition of a "security breach" used in that statute is now incorporated by reference into chapter 449, HRS, in a new section that mandates that a licensed escrow depository notify the Division of

Financial Institutions ("DFI") promptly in the event of a security breach at a licensed escrow depository involving the personal information of individuals. We note that chapter 487N only addresses customer notification, leaving the regulator "out of the loop". The proposed new section in chapter 449, HRS closes the loop by requiring notification of a security breach be given to DFI, so that, as the company's regulator, we can be aware of and monitor, to the extent necessary, the remedial action being taken by the affected escrow depository.

2. DFI strongly opposes HEA's proposal to amend the proposed language of new HRS subsection 449-1.8(b), so as to exclude from complaint statistical data compiled by DFI "[a]ny complaint that is deemed invalid or unjustifiable". (Note: HEA has incorrectly cited HRS Section 449-1.8(d), on this point, in its Senate testimony dated March 2, 2009.) We point out that individual complaints are neither disclosed nor publicized by DFI. Only complaint data of a broad statistical nature is compiled and made available to the public, including the number of complaints against a licensee where it was determined that there was no violation of law. Complaints that are determined to be without merit ("invalid or unjustifiable" in HEA's language), would be classified by DFI as "no violation of law" in our complaint disposition coding for statistical purposes. In this respect, our proposed amendment to HRS §449-1.8(b) exactly tracks DFI's complaint data disclosure practices under the Code of Financial Institutions,

HRS Chapter 412. We therefore believe that HEA's concerns or objections in this regard are unfounded and based on a misunderstanding of the statistical data that will be disclosed. Further, asking an agency to ignore certain complaints when compiling complaint statistical data is arguably unethical, and skews the data being compiled to defeat the objective of compiling accurate information about the number and nature of all complaints generated, whether they are ultimately found to be justified or without merit. Moreover, complaints classified in the statistical data as "no violation of law" should, if anything, benefit the industry by indicating that all complaints so categorized were determined by DFI to be without merit to the extent that those complaints had asserted an alleged violation of law.

3. HEA has objected to DFI's proposal to delete the "bona fide error" language in §449-4 at the same time that we are seeking to amend the amount of any administrative fine imposed under the statute from the current inflexible amount of $5,000 to "a fine of up to $5,000." These proposed amendments would allow the DFI Commissioner appropriate and necessary latitude to appreciate whether or not an error that resulted in a violation of the statute was made carelessly, albeit unintentionally. If, for example, a clerical error were determined to have been the result of extreme carelessness, evidencing unacceptably lax business practices, the language in the statute which HEA wishes to retain would

completely preclude the Commissioner from assessing a fine in any amount as a penalty for unacceptable business practices. Accordingly, we submit that it is appropriate that the good faith provision should now be deleted, and that the statute provide, instead, a variable fine amount, which can be adjusted based on the Commissioner's judgment, as the industry's statutorily appointed regulator, of the gravity of a particular violation, fully taking into account whether an error appears to have been made in good faith or not.

4. At our last meeting with representatives of HEA, when the concept of putting a mediation provision into the statute was raised by HEA, we expressed to HEA our view that this type of provision should more appropriately be inserted into the contractual agreement of an individual escrow depository with its customer, should a particular escrow depository desire to secure its customers' agreement on that subject. DFI can see no need or public policy reason to endorse this remedy (which is frequently perceived to be "consumer unfriendly" since it limits the consumer's rights and recourses) in the statute, when such an amendment is not required in order for any particular licensed escrow depository to stipulate and require mediation as a contract provision in its agreements with its customers. Our view is that regulators should only statutorily mandate a particular provision when there is a clear public policy reason to enforce that provision as a requirement of the law, and we do not see this being the case with

mediation. It is difficult to see that there would be a public benefit or public policy reason to legislatively compel mandatory mediation for all escrow depository customers. Moreover, it is our understanding that HEA does not speak for all of the currently licensed Hawaii escrow depositories in advocating a statutory provision to compel mediation in escrow transaction disputes.

5. (a) Section 5 of this measure, which would amend HRS Section 449-5.5, presents several issues that now need to be addressed. The current minimum net capital requirement of $50,000 for an escrow depository has not been modified since it was enacted in 1973, with the result that 36 years later, the law no longer requires a sufficient minimum level of capitalization in relation to the size and volume of the escrow transactions that escrow depositories routinely handle. We conservatively estimate that housing prices in Hawaii, broadly speaking, are greater today by a factor of 10, as compared to prevailing prices in 1973. (b) At the same time, to better reflect prevailing accounting terminology, and to more clearly focus on a company's tangible net worth without taking into account a company's intangible assets, such as goodwill, the value of which is arguably often subjective and difficult to accurately value, we propose to replace the term "net capital" in HRS Section 449-5.5 by substituting the term "tangible net worth" instead. This amendment is now perceived to be necessary in order to harmonize the language of that section with a new definition of "tangible net

worth" that was recently added to Senate Bill No. 887, S.D. 1 by the Senate Committee on Commerce and Consumer Protection. (c) For reasons we do not understand, the Senate Committee on Commerce and Consumer Protection also amended HRS Section 449-5.5 by introducing new language relating to any partnership, limited liability corporation [*sic*], limited liability partnership, or other business entity regardless of corporate designation that engages in escrow depository business under HRS Chapter 449. That language conflicts with the existing requirement set forth in HRS Section 449-5 stating that "[n]o person shall act as an escrow depository in this State unless it is a corporation licensed to do so by the commissioner." Other references to the requirement that a Hawaii escrow depository be organized only as a corporation can be found throughout the statute, including HRS Sections 449-6, 449-7.5, 449-17 and 449-22. While DFI has previously contemplated the possibility of amending the statute to allow an escrow depository to organize as, or convert to, a limited liability company, that change was envisioned as part of a more comprehensive overhaul of the statute, which the industry has failed to support in each of the last four legislative sessions. DFI has never contemplated broadening the choice of entities that may apply for an escrow depository license to include partnerships, limited liability partnerships "or other business entity regardless of corporate designation". Given the fiduciary duties and liability of licensed escrow

depositories, DFI considers such an amendment inadvisable and inappropriate and we are strongly opposed to such an amendment to the statute. Moreover, introducing such an amendment to HRS Section 449-5.5, without making necessary related amendments elsewhere throughout HRS Chapter 449 and at Section 12 of this measure, would render this measure seriously defective. Since an escrow depository must be a corporation, and cannot presently be organized as any other kind of business entity, we recommend that this conflict be cured by deleting the prior Senate committee's proposed language in HRS Section 449-5.5 which makes reference to any type of business entity other than a corporation. A proposed amendment to HRS Section 449-5.5 to accomplish all of the necessary changes to the section that I have just discussed is offered as Attachment "A" to my written testimony today. The resulting amendments to that section will address and cure these current shortcomings in the statute by retaining the requirement that an escrow depository be organized solely as a corporation and by increasing the minimum tangible net worth required for all new and existing escrow depositories from $50,000 to $250,000, in order to maintain an adequate level of protection for consumers in view of the average size of present day real estate escrow transactions in Hawaii. An escrow depository that does not have the new required minimum tangible net worth on the effective date of the Act, will have until July 1, 2010 to meet the requirement.

6. In a similar vein, to more realistically reflect the size and volume of present day escrow transactions, amendments are proposed by the Department to increase the minimum amount of errors and omissions insurance coverage from $100,000 to $250,000, increase the required escrow bond from $100,000 to $200,000, and increase the minimum fidelity insurance coverage from $50,000 to $125,000, all effective as of July 1, 2010.

7. With regard to various new definitions that have also been proposed by HEA in its recent Senate testimony, we note that HEA proposes to amend the existing definition of "escrow" without having explained why the current definition does not meet the industry's purposes. DFI believes the existing definition is not only superior to that proposed by HEA but also clarifies that, for purposes of regulation of the industry under HRS Chapter 449, escrow involves only <u>real property</u> transactions. HEA's proposed definition ignores this distinction, which would invite DFI regulation of all escrow transactions, both real and personal property, handled by the industry, something which we understand the industry has never wished to invite or propose. The proposed new definitions of the terms "fiduciary agent" and "escrow duties" are without valid legal justification since, to the best of our knowledge, those terms are not used anywhere in HRS Chapter 449 and accordingly there is no need to define these terms.

8. The Department requests that the proposed new section entitled "Education", which was added to Senate Bill No. 887, S.D. 1, by the Senate Committee on Commerce and Consumer Protection at the request of HEA, be deleted for the following reasons. The Hawaii Escrow Association is presently, and always has been free to provide its member escrow depositories with any educational materials, updated legislation, and any other industry-pertinent information or materials on a regular basis, without the need for a statutory mandate to do so, as is being proposed by this particular amendment. One consequence – perhaps unintended – of such an amendment, if enacted, is that HEA would open itself to periodic regulatory scrutiny by DFI to ascertain that the Hawaii Escrow Association is, in fact, at all times, adequately discharging its statutorily mandated duties with regard to the education of its members and could even become subject to enforcement provisions, including administrative penalties under HRS Section 449-4, if it were to be determined that HEA had failed to properly and adequately discharge its mandated duties relating to the education of its members. Consequently, in our view, the association would be well advised not to seek the enactment of such an amendment to HRS Chapter 449, but rather to continue to fulfill such educational functions on its members' behalf, if it so chooses, as a component of the association's mission statement and/or

its internal policies and procedures. Alternatively, the industry may wish to consider proposing, in future legislative efforts, a fully described continuing education program requirement that would be applicable to all licensed Hawaii escrow depositories, rather than limiting to HEA members only the currently proposed courses and materials – which we note are both nonspecific as to content and unquantified as to hours of proposed continuing education to be provided per year.

With the changes requested today, the Department strongly supports this bill and asks for your favorable consideration. Thank you for the opportunity to testify. I would be happy to respond to any questions you may have.

[PLEASE REFER TO ATTACHMENT "A" ON THE NEXT PAGE]

ATTACHMENT "A"

SECTION 5. Section 449-5.5, Hawaii Revised Statutes, is amended to read as follows:

"**§449-5.5 [~~Net capital.~~] Tangible net worth.** The tangible net [~~capital~~] worth of any corporation engaging in the escrow depository business under this chapter shall be not less than [~~$50,000.~~] $250,000. A corporation in lieu of the tangible net [~~capital~~] worth requirement may alternatively file a bond for [~~$50,000~~] $250,000 conditional upon its satisfactory performance of escrow conditions and satisfaction of all escrow liabilities. The amount of the minimum tangible net [~~capital~~] worth of [~~$50,000,~~] $250,000, or the bond, or a combination of both tangible net [~~capital or~~] worth and bond totalling [~~$50,000~~] $250,000 shall be maintained at all times by the licensee.

[~~Licensees in operation on May 24, 1973, pursuant to this chapter with a net capital of less than $50,000 shall increase its net capital to $50,000 or file a bond for $50,000, or take action so that a combination of its net capital and bond totals $50,000, before May 24, 1978.~~]"