The Claims Corner: Revenge Equity Theft, Safeguards to Avoid a Potentially Costly Policy Loss

Description

This article concerns a business partnerâ??s theft of the equity in the limited liability companyâ??s real property and business assets, following a dispute over the partnersâ?? profit-sharing provision, by falsifying documents to represent he had authority to mortgage the LLCâ??s realty. While claims such as these are not uncommon and can result in expense and lengthy litigation, the intent of this article is to focus on the lack of due diligence and how such a scenario might be avoided. The following is based on an actual claim but names and identifying details have been altered for privacy reasons.

It was business as usual for Jack and John at the U Wreckâ??em We Fixâ??em Body Shop, LLC (â??Body Shopâ?•). Jack and John were long-time friends. Jack is a wealthy entrepreneur, while John is a top-notch autobody repair technician. John suggested to Jack that the two partner up to open the Body Shop. Jack provided the capital and John the sweat equity. John allowed Jackâ??s attorney to create the Operating Agreement for the Body Shop. John did not have an independent attorney review the Operating Agreement and did not fully understand what he was signing. You see where this is going!

Body Shop purchased a large existing facility with Jackâ??s cash and title vested in the Body Shop. Pursuant to the Operating Agreement, John ran the day-to-day operation of the Body Shop, but Jack was appointed the member-manager, overseeing the business, accounting, and legal affairs. Jack held a 75% membership interest and John the remaining 25% membership interest in the Body Shop. Jack did not draw a salary, but John did. In due time, the Body Shop was raking in the cash.

Jack and John began to receive distributions commensurate with their respective membership interest. Even with Johnâ??s salary, his net profit distribution was less than the distribution paid to Jack. That caused friction as John was working 12-hour days, six days a week. John sought to renegotiate the membership interest, but Jack refused.

The Operating Agreement contained a forced sale provision that gave Jack the ability to purchase Johnâ??s membership at a significantly reduced value. To further compound Johnâ??s frustration, the Operating Agreement contained a non-compete and non-solicitation clause for a two-year period, leaving John with no ability to open up a new body shop and earn an income. John consulted counsel to better understand the terms of the Operating Agreement, following which John understood that he was at a grave disadvantage. The Body Shopâ??s real property and business were valued at $4 Million.

John knew he could not sell the business, land and building out from under Jack without Jack noticing. So, John decided to obtain a $2 Million loan from a hard-money lender (â??Lenderâ?•), the proceeds of which John advised would be for the investment of new equipment and the like, but in actuality John would take the money for himself. There was one problem: the loan policy title commitment issued by the title insurer through its agent, Title Agent, required a copy of the Operating Agreement and a

resolution that all members approved of the loan and mortgage. Under the Operating Agreement, only Jack had the authority to obtain loans on behalf of Body Shop and to encumber same against the land.

Unbeknownst to Lender and Title Agent, John created a False Operating Agreement, reflecting John as the sole 100% member. John also filed an amended Articles of Organization with the State Corporation Commission, disclosing himself as the managing member of the Body Shop and as the registered agent, and thereby removing Jack as the managing member. Through pretense, John appeared to be the sole owner of the Body Shop. Title Agent accepted the False Operating Agreement but never verified any of the business information contained on the State Corporation Commission website. Lender funded the $2 Million loan, a mortgage was recorded against the title of the land, a UCC-1 recorded against the business assets, and, of course, a loan policy issued in the amount of $2 Million. John paid the mortgage payments with company funds, concealing same from Jack, that is until Jackâ??s accountant inquired why there was a discrepancy in the payables. Thatâ??s when Jack found out about the Lenderâ??s mortgage.

Litigation ensued between Jack and John, and Lender was joined as a party to void the Lenderâ??s mortgage as fraudulent. Title Agent was also sued. Lender submitted a title insurance claim requesting coverage under the loan policy seeking a defense and to be indemnified for any loss arising from Johnâ??s fraud. The title insurer retained counsel for lender and incurred significant attorneysâ?? fees.

While Lender may have a viable defense as a bona fide mortgagee, this article is about Title Agentâ??s expected due diligence required to discover the fraud, even though a viable but costly litigation defense is available.

What could the Title Agent have done differently to catch Johnâ??s fraud? After all, the Title Agent was in the best position to discover the fraud. And the information was readily available for the Title Agent to discover.

For starters, the Title Agent should have searched the State Corporation Commission website by performing a name search of the Body Shop. The State Corporation Commission website allows a name search of the business entity, which would disclose information such as the articles of organization, the managing member, the registered agent, addresses and emails. In that regard, the Title Agent should have reviewed Body Shopâ??s State Corporation Commission filings to:

- Look for any recent changes in the Body Shopâ??s managers, officers, etc.
- Review prior entity filings that identify the person now â??authorizedâ?• and those previously authorized to sign on behalf of the entity.
- Request the contact information for other members, officers to verify the authority to convey title, encumber with a mortgage.
- Contact the person who prepared initial filing for the entity to confirm â??newâ?• officer or manager information.

Had the Title Agent followed the above-suggested protocols, Title Agent would have discovered that John filed Amended Articles of Organization removing Jack as the managing member, just prior to the loan closing. That is a red flag. The Title Agent could have then requested for John to provide Jackâ??s contact information so that the Title Agent could contact Jack. Likely, John would not have provided Jackâ??s contact information, forcing John to abandon the loan closing and thereby prevent the fraud to the Lender and the issuance of the loan policy. And, if John did not provide Jackâ??s contact

information to the Title Agent, that would be a red flag to the Title Agent, who should then undertake efforts to track down Jack and inquire about his interest in the Body Shop, at which time Jack would have put a stop to Johnâ??s fraudulent scheme.

The Title Agentâ??s simple review of the State Corporation Commission website would have alerted the Title Agent to changes in the management of Body Shop, oddly right before the loan closing. That should always be construed as suspicious by a title agent and should always prompt a title agent to undertake the above protocol, or a protocol that has been proven to be effective for the title agent.

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