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The Suborned Subescrow

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Midcourse Corrections

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The first time I read the opinion in *Markowitz v Fidelity Nat'l Title Co.* (2006) 142 CA4th 508, 48 CR3d 217, reported at p 402, I was convinced that it was wrong. Indeed, each time I reread it, that same feeling arose, although by now I have become persuaded that it really was decided correctly.

Markowitz sued Fidelity because, as part of a refinancing—where Fidelity was supposed to have an old deed of trust held by the original sellers reconveyed and replaced with a new one in favor of the refinancing lender—it (Fidelity) recorded the new one but did not get the old one reconveyed, thus leaving Markowitz's title subject to both the old and the new liens. While his major adversaries were the holders of the old deed of trust, who were refusing to release it without more money, he also sued Fidelity for (among other things) breach of escrow contract and breach of escrow agent fiduciary duties.

What caught my attention—and what seemed wrong to me—was the court's conclusion that Markowitz had no standing to complain about Fidelity's behavior because he was not a party to the instructions given to it. The sole giver of instructions to Fidelity, the court said, was City National Bank, the refinancing lender. How, I asked myself, could Jill Culver, the named escrow agent, possibly record a deed of trust against Markowitz's title without an instruction from Markowitz—or even worse, when Markowitz was not even a party to the escrow?

The answer is that she couldn't do so, if she were really an escrow agent—but she certainly could do so, if she weren't functioning as an escrow agent. In this transaction, Culver was operating as a "subescrow" agent; she had been hired by the bank to record the new deed of trust (and reconveyance of the old), and to disburse funds when her employer (Fidelity) was prepared to issue a title policy insuring the bank. This was not a conventional loan escrow where lender and borrower submit their respective documents and valuables for transfer to the other on the occurrence of the mutually stated conditions. Culver was working solely as an agent of the bank in this transaction and needed no instructions from Markowitz to do what was required of her.

Subescrows are a phenomenon of the southern part of the state and one with which we in the north are largely unfamiliar. Their existence is connected to the widespread operation of independent escrow companies in the south and the attendant worries that those facilities generate when large sums of money have to be entrusted somewhere; large reputable title companies, on the other hand, are safe depositories for money even when they are not functioning as true escrows.

There is a good explanation of this in *State v PriceWaterhouseCoopers LLP* (2005) 125 CA4th 1219, 1279, 23 CR3d 529, rev'd on other grounds (2006) 39 C4th 1220, 48 CR3d 144, which is unciteable (but, I hope, quotable):

An understanding of how ORTC [Old Republic Title Company] operates in Southern California is helpful. There, escrow transactions are typically handled by independent escrow companies. Buyers, sellers and lenders alike contract directly with the escrow company for escrow services. The parties to a transaction address their escrow instructions to the escrow company, which in turn performs the instructions without any involvement of companies such as ORTC. Buyers, sellers and borrowers have no direct contact with ORTC. However, lenders deposit their funds with ORTC. This latter arrangement is called a subescrow, although it is a depositary relationship and not an escrow. A senior vice-president of Old Republic declared that lenders often are "unwilling to deliver loan funds to independent escrow companies because those companies frequently lack the size or longevity associated with solvency and liquidity." Thus, they insist on depositing their funds with a company such as ORTC.... The trial court noted that in Southern California, buyers were parties to escrows conducted through independent escrow companies, not ORTC. The situation in Southern California was very different because the buyers were not customers of ORTC and had not entered into any agreements with ORTC.

Up north, on the other hand, the ownership of escrows by title companies eliminates that particular need, although I understand that they are often used in refinancings by a lender to guarantee that its loan funds are not disbursed until its deed of trust is recorded and insured, all of which can be done by a title company as its agent, without the need for a "formal" escrow involving the borrower. (Indeed, I believe City National Bank would have done the same up north as it did in *Markowitz* down south.)

The term "subescrow" is quite misleading: Subescrows have nothing to do with escrows. There was no escrow in the Markowitz loan transaction. The Markowitzes signed and delivered a loan agreement, note, and deed of trust directly to City National Bank; they did not sign escrow instructions and did not go through an escrow. They merely had to hope that the bank would not misuse what they had signed before giving them the money it had promised. The bank, for its part, sent the promised money to its trusted agent, Fidelity, with instructions to disburse it when stated conditions were met. Since it was only following the instructions of one party, Fidelity functioned not like an escrow agent, listening to two principals, but only as an ordinary agent obeying its single master, City National Bank. There was no "one person" and "another person" as Fin C §17003 contemplates for true escrows.

It is easy to forget that a transaction, even a big one, can be accomplished without an escrow. X can give her deed or mortgage to Y without opening up an escrow to do it. Y can record that document (if it was properly signed and notarized) without needing instructions from X to do so, at least as long as it is not done in the teeth of an instruction not to record it. If Y can record the deed/mortgage to him, he can also ask Z, his agent, to record it for him (or to do so when Z is satisfied that some other conditions have also been met). Z can do all this without any need to get confirmation from X, and can call it a subescrow when it does so.

The reason I said (at the start of this column) that I reached the wrong conclusion every time I read the opinion is because nowhere in the opinion is this distinction ever really made. The court mentions that a subescrow was involved, but then—throughout all of its reasoning—speaks as if a true escrow were involved, constantly referring to Fidelity as an escrow agent and citing authorities dealing with escrow agent responsibilities. Given that Fidelity was a lender's agent, not an escrow agent for the lender and borrower, none of those references or arguments applies. I only hope that others will not misread those statements to think that they can safely be used to guide real escrow agents' conduct.

Much of the trouble starts with the fact that California escrow law itself does not make much sense. Historically, a valid escrow required an irrevocable delivery to the escrow agent. If the grantor deposited the deed with any right to recall it, the receiver took the deed as his agent—and not as an escrow agent—which meant that there was no relation back of the second delivery to the first and that the grantor's death, before the second delivery by the agent to the grantee, terminated the agent's authority and rendered any second delivery meaningless. (Thus, in all those cases where the grantor said to the agent, "Deliver this to the grantee on my death, unless I change my mind," delivery was sure to fail, and people would not find that out until the grantor was dead and it was too late to do it right.) California cases still have that requirement (*Hayden v Collins* (1905) 1 CA 259, 263, 81 P 1120):

[I]t is absolutely essential to the validity and effectiveness of a deed in escrow that it be delivered to a third person for the grantee, beyond any power in the grantor to recall or revoke it. The grantor must clearly and unequivocally evidence an intent and purpose to part with the possession and control of the deed for all time. In short, the delivery and transfer must be irrevocable.

If that were the general rule for escrows, and escrow officers took that principle seriously, no escrow would ever be valid. Few depositors ever intend to waive the right to change their minds when depositing papers into escrow, and most escrow agents have a policy of refusing to accept irrevocable instructions. Commercial escrows are not really escrows at all, in the historic sense of the word, because the parties to them only have a conditional intent, *i.e.,* to go through with the deal only if the other side performs. But it hardly matters, because if they have an underlying enforceable contract, they are bound to perform whether they want to or not. No seller has a defense to the buyer's specific performance action by saying, "But I don't want to perform the contract or deliver my deed." The obligation of contract replaces the need for proper intent in delivery.

This would not be a problem if our courts had described the situation by saying that there either must be an irrevocable delivery *or* an enforceable contract for a second delivery from the escrow agent to the grantee to be valid and relate back. But instead, we have made it sound like one rule all jumbled up. Thus, Witkin says (12 Witkin, Summary of California Law, *Real Property* §306 (2005)):

The prevailing rule ... is that the grantor and grantee must enter into a valid and binding contract in order to make an irrevocable deposit. If there is no such contract, the grantor can recover the deed from the escrow holder at any time before the condition is performed....

I suspect escrow officers pay as little attention to that statement as to the earlier one about irrevocable intent, and do not attempt to determine the validity (or even the existence) of any underlying contract between the parties.

The discrepancy between these two rules, for me, is best illustrated in *Holland v McCarthy* (1916) 173 C 597, 603, 160 P 1069, in which the court stated that the enforceable contract requirement does not apply "where the transaction is not to consummate a contract of sale, but for the purpose of effecting a gift. Such transactions are governed by a different rule, and a contract is not an essential part thereof." This sounds like saying, "If you have a contract, you need a contract, but not if you don't have a contract." The real explanation is not that you need to have a contract in order to have an escrow, but that even when you don't have an escrow (because of conditional intent), the contract underlying it can be specifically enforced anyway, as long as the contract is specifically enforceable.

Learning About New York Mortgage Practice

While I was preparing this column, I happened to receive a copy of Stein on New York Commercial Mortgage Transactions (LexisNexis 2006), by Joshua Stein, a Latham & Watkins attorney whom I previously persuaded to comment for us on nonrecourse carveouts (see the Editor's Take on *Aozora Bank, Ltd. v 1333 N. Cal. Blvd.* (2004) 119 CA4th 1291, 15 CR3d 340, in 27 CEB RPLR 134 (Sept. 2004)). Practitioners who engage in commercial real estate deals often enough brush up against New York practice, so I examined this work to see what it told me about how this situation would play out there. It didn't cover this particular transaction (they have attorney-supervised "closings" rather than escrows most of the time), but I did conclude that it was a generally useful book, and one that I will frequently turn to.