2001

Escrow agent’s duty of care to nonparties: Summit Fin. Holdings v Continental Lawyers Title, (2001)

Roger Bernhardt
Golden Gate University School of Law, rbernhardt@ggu.edu

Follow this and additional works at: http://digitalcommons.law.ggu.edu/pubs
Part of the Property Law and Real Estate Commons

Recommended Citation
http://digitalcommons.law.ggu.edu/pubs/288

This Article is brought to you for free and open access by the Faculty Scholarship at GGU Law Digital Commons. It has been accepted for inclusion in Publications by an authorized administrator of GGU Law Digital Commons. For more information, please contact jfischer@ggu.edu.
Escrow agent’s duty of care to nonparties:

*Summit Fin. Holdings v Continental Lawyers Title*, (2001)

Roger Bernhardt

Escrow holder that follows principal’s escrow instructions owes no duty of care to nonparties to the escrow.

*Summit Fin. Holdings, Ltd. v Continental Lawyers Title Co.* (2001) 87 CA4th 1379, 105 CR2d 352

Talbert Financial (Talbert) made a $425,000 loan secured by a deed of trust, which Talbert immediately assigned to Summit Financial Holdings (Summit). Talbert recorded the assignment of the deed of trust, but neither Talbert nor Summit notified the borrower of the assignment, as required by CC §2937. A year later, the borrower refinanced the loan—*i.e.*, paid off the loan with the proceeds of a new loan—using a title company as escrow holder. Summit was not a party to the escrow. The title company prepared a preliminary title report showing the Talbert deed of trust and the assignment from Talbert to Summit. Talbert submitted a payoff demand requesting that payment be made to Talbert (not Summit), and the parties to the escrow instructed the title company to pay off the loan by issuing a check to Talbert. At close of escrow, the title company paid Talbert in accordance with those instructions. Talbert did not remit the funds to Summit, in breach of their assignment agreement.

The borrower later filed for Chapter 11 bankruptcy. In connection with a sale of the borrower’s property free of liens, the bankruptcy court disallowed Summit’s lien on the ground that the payoff to Talbert in the refinancing extinguished the borrower’s obligations under the original loan. Summit then sued the title company for negligence, claiming that the title company should have issued the payoff check to Summit instead of Talbert because it knew of the assignment. Relying on *Kirby v Palos Verdes Escrow Co.* (1986) 183 CA3d 57, 227 CR 785, the trial court held that the title company owed a duty of care to Summit, even though Summit was not a party to the escrow, and breached that duty by paying Talbert instead of Summit.

The court of appeal reversed, holding that the title company did *not* owe a duty of care to Summit. An escrow holder’s primary duty is to strictly perform the instructions of the parties to the escrow. The court held that an escrow holder that follows its principals’ instructions cannot be liable in negligence to a nonparty stranger to the escrow. The court disagreed with *Kirby*’s holding to the contrary, stating that *Kirby* was wrongly decided and should not be followed. Instead, the court followed the general rule that an escrow holder is not liable for failing to do something not required by the escrow instructions, or for a loss caused by following the escrow instructions.

The borrower and the new lender engaged the title company to assist in closing the new loan, and any effect of that transaction on Summit was collateral to the purpose of the escrow. The title company could not have foreseen that Talbert would breach its obligation to disburse the funds to Summit. Moreover, Summit caused its own injury by failing to notify the borrower of the assignment as required by CC §2937. Finally, “imposing a duty here would have the anomalous effect that the original debtor is exonerated from liability on his debt by his agent’s payment to
Talbert but the agent making that payment for its principal becomes liable on that debt.” 87 CA4th at 1390. For these reasons, the court found no basis for permitting Summit to recover from the title company.

THE EDITOR’S TAKE: [Note: Feeling slightly uncertain about what I said below, I sent a draft of this comment to my colleague, Professor Dale Whitman of the University of Missouri, who is the author of the article I cite below, as well as the Reporter for the recent Restatement of Mortgages. His response was so interesting that I have inserted it below, in brackets, as counterpoint to my remarks. RB]

Although the rule announced by the court is clear, I find the circumstances for its application somewhat confusing.

First, as to the underlying bankruptcy litigation and the liability of the borrower, I don’t know what CC §2937 had to do with the matter. That code section requires that notice of transfer of servicing of a debt on one-to-four residential units be given to the borrower. Assuming that this was that kind of property, I don’t see that any transfer of servicing was involved. There is no mention of any servicing agent at all, and the note calls for direct payments to the payee. That should put the assignment of that note under CC §2935, which deals with assignments of the note and mortgage, rather than under §2937. But §2935 concentrates not on whether actual notice was given, but on whether the payment was made “to the person holding such note,” and that fact is not told to us.

[Prof. Whitman: I agree with you. The term “transfer of servicing” is routinely understood in the mortgage banking industry to mean a transfer of only the servicing rights, and not an assignment of the underlying obligation (note). Of course, the “evil” that the legislature refers to in the introduction to §2937 is equally a problem when the note itself is transferred with no notice to the obligor. So it would have made sense for §2937 to define “transfer of servicing,” and to define it broadly enough to include assignment of the obligation. But the legislature didn’t provide any definition at all, and in this situation I think a court would have to accept the ordinary understanding of the term in the industry. Incidentally, §2937 isn’t unique: federal law also requires notification of the borrower when servicing is transferred. See 12 USC §2605, adopted by Congress in 1990 as part of the Real Estate Settlement Procedures Act of 1974 (RESPA). But the annotations to that section, likewise, give no indication that “transfer of servicing” would be construed to include transfer of the obligation itself.]

Civil Code §2937 has never been interpreted, and may have been intended to displace §2935 entirely when small residential properties are involved. If so, the debtor may safely continue to pay his original creditor no matter how many times the actual note and deed of trust have been transferred and the transfers recorded, so long as he has never received the required statutory notice. For other properties, §2935 would still apply, meaning that a debtor should still require her creditor to produce the note to prove that he still has it before she pays him (the infamous “payment rule”). See Whitman, Reforming the Law: The Payment Rule as a Paradigm, 1998 BYU L Rev 1169. And, because an assignment of a single-family mortgage note might not constitute a transfer of its “servicing,” I think that is good advice in any case. It may not be
realistic to expect debtors to require production of the note regularly, and the risk of loss is small when a reputable lending institution is involved, but it can avoid a painful loss.

[Prof. Whitman: Although the opinion never mentions any servicing agent, that doesn’t mean there wasn’t one. Noninstitutional lenders routinely use them. But even if there was a servicing agent, there is not the slightest indication that (1) the servicing was transferred, or (2) the transfer of any servicing had anything to do with the problem that arose in the case.]

Second, as to the escrow agent’s behavior, on what basis did it honor Talbert’s (the creditor/assignor’s) payoff demand? It is unlikely that it would send Talbert the money without requiring Talbert to surrender the note (marked “paid”) and the deed of trust (for reconveyance). If that actually happened, the note and deed of trust would still be valid but for §2937. It is more likely that the escrow agent did receive these documents from Talbert, which means that Talbert retained them despite the assignment to Summit. If so, then Summit brought the loss on itself regardless of which code section applies: under §2937 it gave no notice to the borrower, and under §2935, its failure to take possession of the note made its recording of the assignment ineffectual.

[Prof. Whitman: We’re only speculating, but I would bet that (contrary to your supposition) the title company did indeed send the payoff check to Talbert without requiring him to produce the note first. Escrow companies and other closers nearly always do so, in my observation. If your supposition is correct, and if Talbert did indeed retain the note, then if the note was negotiable under Article 3 of the Uniform Commercial Code [in California, Division 3 of the California Commercial Code], the right to payment was not legally and effectively transferred to Summit, and the title company did nothing that could be remotely construed as wrong. However, if my supposition is correct, then the title company was indeed negligent. Moreover, the title company had already issued a preliminary title report showing the assignment of the mortgage. In all probability, a copy of that title report was actually in the hands of the escrow officer. Under these circumstances, even someone like me who believes the payment rule is wrong and ought to be changed would be hard-pressed to exonerate the escrow officer. I bet he had actual knowledge that he was sending the check to the wrong party.]

Whether or not the escrow agent owed a duty of care to Summit or fell below that duty, it seems clear to me that Summit itself was pretty careless. —Roger Bernhardt (and Dale Whitman)