No. COA 08-133 JUDICIAL DISTRICT ELEVEN-B

NORTH CAROLINA COURT OF APPEALS

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<tr><td>WILLIAM WOOD JOHNSON and wife,
SUZANNE WAYNE JOHNSON,

Plaintiffs/Appellants,

vs.

TIMOTHY P. SCHULTZ and wife,
SHELLEY D. SCHULTZ, DONALD A.
PARKER, JERRY HALBROOK, trustee
and STATE FARM BANK, F.S.B.,

Defendants/Appellees.</td><td>)
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)</td><td>From Johnston County
No. 06 CVS 2148</td></tr>
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BRIEF AS AMICUS CURIAE

(The North Carolina Land Title Association)

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QUESTION PRESENTED

Whether the existence of title insurance is a proper factor to be considered when allocating the risk of loss between a buyer and seller due to the defalcation of closing funds by an attorney in a residential real estate transaction.

ARGUMENT

The North Carolina State Bar ("State Bar" or the "Bar") has taken the position in its *amicus curiae* brief that the risk of loss associated with the embezzlement of closing funds in a residential real estate transaction should, in every case, fall on the buyer, even if the defalcation occurs after closing. The State Bar's position in this regard rests principally on two grounds. First, the State Bar contends that the attorney for a "typical real estate closing"[1] is always retained by the buyer and always acts as the buyer's agent, and not the seller's agent, for purposes of the closing. The loss from any dishonest acts of the buyer's agent, therefore, should fall on the buyer. Second, the State Bar contends that the risk of loss should fall on the buyer because the buyer is protected in some cases by a form of title insurance known as a Closing Protection Letter. The Bar contends the availability of this form of title insurance signifies that the parties to a residential real

[1] The term "typical real estate closing" is not defined in the record, but it finds frequent application in the State Bar's *amicus* brief without definition or supporting authority. See section I, *infra*.

estate transaction have already allocated the risk of loss to those parties who may be protected by insurance.

As will be discussed in the paragraphs to follow, neither position withstands scrutiny. The closing attorney is not always chosen by the buyer and does not always represent only the buyer. In fact, the attorney is often chosen by the seller and commonly represents the seller. *See* Affidavit of C. Thomas Steele ¶ 6 (R. p. 223). Additionally, the approach advocated by the State Bar would require the Court to forego a substantive analysis of how to properly allocate the loss on the merits under relevant legal and equitable considerations. In essence, the State Bar is asking the Court to apportion the loss to the buyer due to the existence of insurance coverage even in those cases in which there may be a legal or equitable basis for allocating the loss otherwise. Contrary to an assertion made by the Bar in its *amicus* brief, the existence of insurance coverage is decidedly not a relevant equitable consideration. To premise liability in this case and in future cases of attorney defalcation on the mere existence of insurance coverage would be unprecedented in American jurisprudence, contrary to existing law, and would extend coverage to a class of risks not contemplated by title insurers under Closing Protection coverage.

I. THE CLOSING ATTORNEY IS NOT SIMPLY AN AGENT OF THE BUYER FOR PURPOSES OF A REAL ESTATE CLOSING.

The first fallacy in the State Bar's argument that the buyer always[2] chooses the closing attorney and therefore always acts as the buyer's agent only is the Bar's unspoken assumption that there exists such a thing as a "typical real estate closing" or that this phrase has a commonly understood meaning. As noted in footnote one, *supra*, the term "typical real estate closing" is not defined in the record, nor is it possible to precisely define what constitutes a "typical closing." Nevertheless, the Bar frequently makes use of the adjectives "typical" and "routine" in describing real estate closings in its brief even though it is far from clear what constitutes a "typical real estate closing." The State Bar's incorrect assumption that all closings are the same vis-à-vis the legal relationship between the parties and the closing attorney leads to four erroneous premises offered by the Bar in support of its position that the risk of loss should always fall on the buyer.

The four erroneous premises are: (1) that the buyer always chooses the closing attorney; (2) that the closing attorney is always the agent for the buyer; (3) that the closing attorney never represents the seller; and (4) that the buyer is always

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[2] While the State Bar does not explicitly state that the buyer chooses the attorney in every case, the clear implication of the State Bar's argument is that, except in unusual and rare circumstances, the buyer chooses the closing attorney.

(or almost always) insured against defalcation. All four premises are incorrect.

A. Closing Attorneys Often Represent Multiple Parties to a Residential Real Estate Transaction, Including the Seller.

In North Carolina, attorneys frequently represent multiple parties to a residential real estate transaction. *See* Affidavit of C. Thomas Steele ¶ 6 (R. p. 223) (averring that when an attorney prepares the seller's closing documents and is paid a fee by the seller, an attorney-client relationship exists between the attorney and the seller). Rules promulgated by the State Bar are the best evidence for this proposition. North Carolina Rule of Professional Conduct 210 provides that an attorney may represent the buyer, the seller, and the lender in a real estate closing. N.C. Rule of Prof'l Conduct R. 210 (1997) (noting that "after the terms of the sale are resolved, the buyer and the seller of residential real estate have a common objective" and that "common representation is permissible where the clients are generally aligned in interests"). Formal Ethics Opinion 99 FEO 8 affirms that it is ethical for an attorney to represent all parties to a real estate transaction. N.C. State Bar, Formal Ethics Op. 99 FEO 8 (1999). *See also* N.C. Revised Rules of Prof'l Conduct R. 1.7, Ethics Opinion Notes § II ("Real Property Conflicts") (discussing the common representation of the buyer, lender, and seller).

In addition to closings in which the attorney represents the buyer, seller, and the lender - a common arrangement in North Carolina - there are other variations on this theme that further demonstrate that the attorney does not always only act as the buyer's agent. For example, there are occasions on which the closing attorney is chosen by the lender and represents only the lender at closing, but not the buyer. *See* N.C. Rule of Prof'l Conduct R. 40 (1989) (ruling that "for purposes of a real estate transaction, an attorney may, with proper notice to the borrower, represent only the lender ..."). It is also frequently the case that the seller is a developer or a homebuilder, in which case the seller chooses the closing attorney and the attorney represents both the seller and the buyer or the seller only. *See* N.C. State Bar, Formal Ethics Op. 97 FEO 8 (1998) (opining that "it is acceptable for the lawyer who regularly represents a real estate developer to represent the buyer and the developer in the closing of a residential real estate transaction.") In such a case, the attorney typically represents the homebuilder on an ongoing basis and frequently buyers are required by contract to use the seller's attorney for closing. *See* Edmund T. Urban & A. Grant Whitney Jr., North Carolina Real Estate § 23-2 (1996) (noting that homebuilders "usually select the closing attorney").

There are also innumerable other scenarios as diverse as can be imagined, such as, for example, the case in which neither the buyer nor the seller individually choose the closing attorney but instead mutually agree upon an attorney, or in which the conduct of the attorney creates an attorney-client relationship with the seller. *See Cornelius v. Parham, Helms & Kellam*, 120 N.C. App. 172, 175, 461 S.E.2d 338, 340 (1995) (holding "[t]he relation of attorney and client may be implied from the conduct of the parties, and is not dependent on the payment of a fee, nor upon the execution of a formal contract").

Contrary to these authorities, which ironically are nearly all found on the State Bar's Web site, the Bar's *amicus* brief assumes without actually demonstrating that the buyer in the "typical real estate transaction" always chooses the closing attorney and that the attorney acts as the buyer's agent. State Bar *Amicus* Brief §§ I, I(B), and I(C). The State Bar contends that in the "typical residential real estate closing," the buyer selects the attorney and that "[w]hile the buyer's lawyer may prepare the deed ... he or she is still acting as the buyer's agent." *Id.* § I(C).[3] As authority for this proposition, the State Bar cites N.C. Formal Ethics Opinion 2004 FEO 10, which stands for an entirely different proposition, namely, that a closing

[3] Note also the frequent use of the phrase "buyer's attorney" throughout the State Bar's brief. The State Bar seems to be taking a position contrary to its own ethics opinions and rules of conduct, in that it simply ignores the possibility of common representation of the parties by the closing attorney.

attorney may represent the buyer and not the seller only if "the lawyer makes specific disclosures to the seller and clarifies her role for the seller." N.C. State Bar, Formal Ethics Op. 2004 FEO 10 (2005). It is important to note that in the case *sub judice*, the record suggests that no such disclosures were made by the closing attorney to the sellers (Plaintiff-Appellant's Brief p. 12), and further that the sellers had received legal services from the attorney on multiple prior occasions. (Johnson Dep. Vol. 1, p. 11) Such facts demonstrate that, under the rule found in Formal Ethics Opinion 2004 FEO 10, the attorney in the present case should be deemed to have represented both the buyer and the seller.

The Bar goes on to suggest that the closing attorney owes no duty to the seller, and that "nothing in the role of the lawyer indicates that the seller places any confidence in the lawyer as his or her agent ...." State Bar *Amicus* Brief § I(C) at 8.[4] The Bar uses these arguments as a premise to support its contention in Section II of its brief that because the buyer chooses the closing attorney and the "seller had no say in the decision at all," equitable considerations fall in favor of allocating the risk of defalcation on the buyer. The Bar notes

[4] The Bar ignores the fact that sellers frequently repose confidence in the closing attorney to use closing proceeds to pay off existing deeds of trust which secure debts of the seller, to properly prepare the closing documents and documents of conveyance including the proper interests to be conveyed, and to ensure that deeds of trust paid out of closing proceeds are properly marked satisfied following closing.

that "[b]y selecting the closing lawyer ... the buyer at least had some say in who would be handling the funds." *Id.* § II.

The Bar's argument fails, however, because, as demonstrated above, it is often the case that the buyer does <u>not</u> choose the closing attorney, and frequently the attorney represents the seller in real estate closings to the same extent as the buyer. In practice, it may be difficult to determine with certainty whether an attorney represented the buyer or the seller or both in a given transaction. *See Cornelius*, 120 N.C. App. at 175, 461 S.E.2d at 340. The bright-line rule sought by the Bar fails to account for such multifarious possibilities and is therefore flawed and impractical, for it would premise liability upon a state of facts that would not consistently exist and which would often be in dispute. In other words, the Bar's proposed rule would find application in only those instances in which the attorney was in fact chosen by the buyer and truly represented only the buyer at closing, and only in those instances in which these facts were not in dispute. In any event, the risk of loss should not turn on so arbitrary a fact as which party selected the attorney. Were this to be the standard or even an important factor in determining risk of loss, the parties might prefer to close the deal without the involvement of an attorney.

B. Buyers Do Not Always Have a Closing Protection Letter. The State Bar argues that lenders and buyers "can and typically do insure against the risk of embezzlement ... by the closing attorney." State Bar *Amicus* Brief § II at 12. There are, however, numerous occasions on which buyers do not have the benefit of a Closing Protection Letter. As an initial matter, buyers usually only receive this coverage when a lender is involved in the transaction. John C. Murray, *Closing Protection Letters: What Is (and Is Not) Covered?* 27 (2007)[5] (noting that the Closing Protection Letter, while addressed to the lender, is deemed to have been addressed to the buyer, "thus covering the homeowner as if he had the letter"). On rare occasions, a buyer in a residential transaction will specifically request an owner's Closing Protection Letter, but this is not common. Thus, for transactions in which no institutional lender is involved, the buyer typically does not receive the benefit of Closing Protection coverage. There are also situations in which the "lender" is a person or entity that does not obtain a Closing Protection Letter, such as when the lender is a relative of the buyer or a non-institutional lender. The fact that not all buyers have Closing Protection coverage underscores the NCLTA's

[5]Available at:
http://www.firstam.com/ekcms/uploadedFiles/firstam_com/References/Reference_Articles/John_C_Murray_Reference/Title_Insurance/jm-insured.pdf

contention that the existence of insurance is an improper basis for allocating the risk of loss.

II. THE EXISTENCE OF INSURANCE IS NOT A PROPER FACTOR TO BE CONSIDERED WHEN ALLOCATING THE RISK OF LOSS DUE TO THE DEFALCATION OF CLOSING FUNDS.

In Section II of its *amicus* brief, the State Bar takes the position that the risk of loss of defalcation should fall on the buyer because lenders and buyers insure against the risk of defalcation. If adopted by the Court, this rule would shift in part the Bar's responsibility for the dishonest acts of its members to buyers and their title insurance companies that have no regulatory authority over closing attorneys or the practice of law.

The Bar argues that because buyers and lenders in a "routine residential real estate transaction" may have insurance protection in the form of a Closing Protection Letter, "the parties have already allocated the risk of loss to the buyer." State Bar *Amicus* Brief § II at 13. The Bar's conclusion in this regard imposes a fiction upon the actual understanding of the parties and creates an obligation for title insurers that extends beyond the bounds of coverage agreed to be undertaken by title insurers under existing law. To extend coverage of Closing Protection Letters to the defalcation of the closing proceeds in every case would be contrary to the intent of the Closing

Protection Letter offered by title insurers and would, in effect, judicially enlarge the obligation undertaken by title insurers under Closing Protection Letters.

The standard Closing Protection Letter issued in North Carolina provides coverage to the buyer and the lender for the fraud or dishonesty of the attorney to the extent the fraud or dishonesty "relates to the status of the title ... or to the validity, enforceability, and priority of the lien" of the deed of trust executed in favor of the lender. J. Bushnell Nielsen, Title and Escrow Claims Guide § 14.2 (2d. ed. 2007). This coverage was "carefully crafted to apply only to compliance with instructions that are incidental to the issuance of a title insurance policy." *Id.* Closing Protection coverage primarily contemplates a scenario in which the attorney misappropriates closing funds and fails to pay an existing deed of trust that, if not canceled, will have priority over the insured deed of trust. *Id.* Title insurers have not, however, agreed to cover all monetary losses that may occur in a real estate transaction. *Id.* (stating that a Closing Protection Letter "is <u>not</u> a blanket or far-reaching assurance in the nature of a bond or errors and omissions policy, as to any possible violation of closing instructions ...") (emphasis added). Without overstating the simplicity of the matter, title insurance companies insure title. In the present case, title to the insured property was

good and the lender's deed of trust was recorded with the priority required by the lender. Accordingly, there is no basis upon which to extend coverage to the loss in this case.

As a practical matter, title insurance companies are strictly regulated by the North Carolina Department of Insurance, and premiums are based on a statistical evaluation of sources of loss and risks undertaken. If existing law is modified to enlarge the risk of loss under Closing Protection Letters, this may result in industry changes to the Closing Protection Letter to specifically exclude the additional risk.

In nearly every jurisdiction that has addressed the issue in the present case, courts have held that the party entitled to the funds at the time of the embezzlement must bear the loss. *See* Robert L. Flores, *A Comparison of the Rules and Rationales for Allocating Risks Arising in Realty Sales Using Executory Sales Contracts and Escrows*, 59 Mo. L. Rev. 307, 351 (1994) (noting that the Entitlement Rule was "accepted in every reported opinion in which escrow loss [had] been addressed"); *see also GE Capital Mortgage Services, Inc. v. Avent*, 114 N.C. App. 430, 442 S.E.2d 98 (1994); *Bixby Ranch Co. v. United States*, 35 Fed. Cl. 674, 1996 U.S. Claims LEXIS 79 (1996); *United States v. Neu*, No. 5:04-CV-960 (E.D.N.C. May 17, 2007); *Ward Cook, Inc. v. Davenport*, 243 Ore. 301, 413 P.2d 387 (1966); *Zaremba v. Konopka*, 94 N.J. Super. 300, 228 A.2d 91 (1967);

Craddock v. Cooper, 123 So. 2d 256 (Fla. App. 1960); *Lechner v. Halling*, 35 Wash. 2d 903, 216 P.2d 179 (1950). *Crum v. City of Los Angeles*, 110 Cal. App. 508, 294 P. 430 (1930); 5-47 *Debtor-Creditor Law* § 47.03 at 4(b)(ii)(A)-(D) ("the best apparent solution is to allocate the loss to the party entitled to the property at the time of the defalcation without attempting to justify the result in terms of other areas of law ...").

Although numerous different rationales have been examined by courts to arrive at such a holding, the Entitlement Rule is grounded upon the notion that "risk is thought to ... accompany ownership," Flores, *supra* at 325, and "a loss should lie where it happened to fall unless some affirmative public good will result from shifting it." *Id.* at 327 (quoting Leon Green, *The Thrust of Tort Law, Part I: The Influence of the Environment*, 64 W. Va. L. Rev. 1, 7 (1961)).

The Bar argues that the Entitlement Rule should not apply and that *GE Capital Mortgage Services, Inc. v. Avent* is inapposite to the present case because *Avent* pertained to funds held in escrow by the closing attorney. State Bar *Amicus* Brief § I at 3-5. This is a distinction without a difference; the same principles apply. The issue is to whom the proceeds belonged when the embezzlement occurred, and this is an inquiry that is susceptible of resolution.

In the Offer to Purchase and Contract signed by the parties, "Closing" is defined as "the date and time of recording of the deed." (R. p. 73) In this case, the record reflects that closing had concluded by virtue of delivery and recordation of the deed. (R. p. 218) At the moment the deed was recorded, the closing funds became the property of the seller; at that point, the buyer no longer had any claim to the closing proceeds. An eminently reasonable approach is to treat the loss as the seller's in this case because the property that was misappropriated belonged to the seller in every meaningful sense. This rule applies equally whether the embezzlement occurs one day after closing, a week after closing, or a month after closing.

Even if the Court elects not to apply the Entitlement Rule, the existence of insurance coverage is not a proper basis for deciding how to allocate the loss. Ordinarily, evidence of insurance is inadmissible, for it is unrelated to the substantive inquiry of any case. *Keller v. Caldwell Furniture Co.*, 199 N.C. 413, 154 S.E. 674, (1930); *Featherstone v. Lowell Cotton Mills*, 159 N.C. 429, 74 S.E. 918 (1912). In no area of the law are losses apportioned on the basis of which party has procured insurance. It would be a startling departure from existing law for the relevant inquiry in an attorney-defalcation case to be whether the buyer or seller had the benefit of

insurance. Similarly, a sweeping precedent that the risk of loss should always be borne by the buyer would myopically fail to account for the nuances of fact, law, and equity that exist in nearly every case, any one of which may merit allocating the loss to another party to the transaction. The State Bar's contention that insurance is somehow a relevant equitable consideration in apportioning loss encourages the Court to forego any effort to make a substantive determination as to the rightful bearer of the loss.

CONCLUSION

The NCLTA believes that this case was properly decided on its facts. The ruling sought by the State Bar goes far beyond what is warranted in this case to resolve the instant claim between the parties.

Respectfully submitted this 26th day of June, 2008.

HORACK TALLEY PHARR & LOWNDES, P.A.

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AS AMICUS CURIAE

CERTIFICATE OF SERVICE

The undersigned hereby certifies that the foregoing BRIEF AS AMICUS CURIAE (The North Carolina Land Title Association) was served upon counsel of record for all parties by depositing copy thereof in the United States mail in Charlotte, North Carolina, first class postage prepaid and addressed as follows:

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This 26th day of June, 2008.

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AS AMICUS CURIAE

No. COA08-133

North Carolina Court of Appeals

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WILLIAM WOOD JOHNSON and wife,
SUZANNE WAYNE JOHNSON,
Plaintiffs,

From Johnston
(06CVS2148)

V

TIMOTHY P. SCHULTZ and wife,
SHELLEY D. SCHULTZ, DONALD
A. PARKER, JERRY HALBROOK,
Trustee, and STATE FARM BANK,
F.S.B.,
Defendants.

****

ORDER

The following order was entered:

The motion filed in this cause on the 26th day of June 2008 and designated "Motion of the North Carolina Land Title Association for Leave to File Brief as Amicus Curiae" is allowed. The attached amicus curiae brief shall be printed.

By order of the Court this the 27th day of June 2008.

Witness my hand and official seal this the 27th day of June 2008.

John H. Connell
Clerk of North Carolina Court of Appeals

cc:
Mr. Phillip E. Lewis
Mr. Robert B. McNeill
Mr. Gordon C. Woodruff
Mr. James K. Pendergrass, Jr.
Ms. Katherine Jean
Mr. David R. Johnson

FILED THE 27TH DAY OF JUNE 2008 AT 12:25 PM IN THE OFFICE OF THE CLERK, COURT OF APPEALS OF NORTH CAROLINA