NO. COA08-133 DISTRICT ELEVEN-B

NORTH CAROLINA COURT OF APPEALS

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WILLIAM WOOD JOHNSON and wife, SUZANNE WAYNE JOHNSON, Plaintiffs/Appellants	)	
vs.	)	From Johnston County No. 06 CVS 2148
TIMOTHY P. SCHULTZ and wife, SHELLEY D. SCHULTZ, DONALD A. PARKER, JERRY HALBROOK, trustee, and STATE FARM BANK, F.S.B., Defendants/Appellees	)	

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BRIEF AS AMICUS CURIAE
(The North Carolina State Bar)

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BRIEF AS AMICUS CURIAE
(The North Carolina State Bar)

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Pursuant to Rule 28(i), the North Carolina State Bar ("the State Bar") submits this *Amicus Curiae* brief in support of the Plaintiff-Appellants.

QUESTION PRESENTED

In a typical residential real property transaction, does the seller bear the risk that one of the parties will suffer a loss because of embezzlement by the closing lawyer?

STATEMENT OF THE CASE

Amicus adopts Plaintiff-Appellants' statement of the case.

STATEMENT OF THE FACTS

Amicus adopts Plaintiff-Appellants' statement of the facts.

ARGUMENT

This Court's decision could substantially impact all parties to all sales of residential real property in North Carolina, not just the parties before the Court. The trial court imposed upon the seller a crippling financial loss because the buyer's closing lawyer embezzled the buyer's funds and loan proceeds rather than delivering them to the seller. When the check was delivered to the seller, the closing lawyer's trust account contained insufficient funds to cover that check and other outstanding checks written on the account. On the evidence before the trial court there might have been, at most, a brief window the morning after the late afternoon closing when the check might have been honored had the seller raced to the closing lawyer's bank with the check. While the State Bar is neutral with respect to the rights of the particular parties before the Court, the State Bar urges the Court to consider the broader implications of any decision imposing this risk of loss on sellers in all routine residential real estate closings.

I. THE BUYER ASSUMES THE RISK OF LOSS OF HIS OR HER FUNDS BY THE CLOSING LAWYER UNLESS THE SELLER AUTHORIZES THE LAWYER TO HOLD THE FUNDS OR IS NEGLIGENT IN SEEKING PAYMENT OF THE CLOSING LAWYER'S CHECK AFTER CLOSING.

Appellees urge this Court to adopt a brightline rule that in a typical real estate closing, as soon as the seller delivers a deed to the closing lawyer and receives a check in return, the seller assumes the risk that the funds delivered to the closing lawyer by the buyer for the sales price may be stolen by the lawyer before the check is paid by the lawyer's bank. Appellees ask this Court to extend an equitable principle they contend was adopted by this Court in *G.E. Capital Mortgage Services, Inc. v. Avent*, 114 N.C. App. 430, 442 S.E.2d 98 (1994). *Avent* did not involve the disbursement of funds at a typical North Carolina residential real estate closing. *Avent* involved a seller who elected to allow its sales proceeds to remain in the closing lawyer's trust account long after the closing. There is no reason to believe the Court in *Avent* intended its decision to be used to inflict crushing economic hardship on an innocent seller who received a worthless check at closing.

In *Avent*, a commercial real estate business, G.E. Capital Mortgage Services (G.E.), sold its own residential property. At closing, G.E. agreed that the closing lawyer would hold its sales proceeds in escrow until it could demonstrate that the prior owner's mortgage lien was cancelled of record. G.E. also agreed at closing to deliver the deed immediately to Avent. A month later, before G.E. provided

evidence of clear title, the closing lawyer stole the escrowed funds. Under these atypical facts, the Court correctly held that the closing lawyer embezzled G.E.'s funds and G.E. must accept the loss.

Unlike the situation in *Avent*, the seller in a typical North Carolina closing does not agree that the closing lawyer may deliver the deed immediately to the buyer but hold the seller's funds after closing. In a typical closing, the seller expects payment at closing. The seller leaves the closing with the lawyer's trust account check believing that it is good. This is fundamentally different from the express escrow agreement in *Avent*.

Appellees argue that *Avent* requires the party who was "entitled" to the funds when they were embezzled to suffer the loss. The *Avent* decision recognized that its "entitlement" analysis had to be consistent with the applicable equitable principle, as set forth by the North Carolina Supreme Court:

> Where one of two persons must suffer loss by the fraud or misconduct of a third person, he who first reposes the confidence or by his negligent conduct made it possible for the loss to occur, must bear the loss.

Avent, 114 N.C. App. at 435, 442 S.E.2d at 101 (quoting *Zimmerman v. Hogg & Allen*, 286 N.C. 24, 30, 209 S.E.2d 795, 799 (1974)). The Court in *Avent* concluded both that the seller was "entitled" to the funds at the time of the loss and that its conclusion was consistent with the equitable principle. *Avent*, 114 N.C. App. at 435, 442 S.E.2d at 101. The seller in *Avent* changed the nature of the

funds held by the lawyer from buyer's proceeds to seller's escrow and gave the lawyer the opportunity to embezzle the funds after the closing.

Extending *Avent* to apply to the disbursement of funds at a routine residential real estate closing simply imposes on the seller, the party who did not choose the attorney, the risk that the buyer's lawyer will deliver a bad trust account check. In the ordinary real estate closing, the seller neither "reposes" confidence in the buyer's lawyer nor engages in any negligent conduct. The seller simply receives what he should be able to assume is a good check in exchange for delivery of the deed. Appellees proposed application of *Avent* would detrimentally impact the manner in which real estate closings are conducted in North Carolina.

A. CHARACTERISTICS OF A TYPICAL REAL ESTATE CLOSING IN NORTH CAROLINA.

In a typical North Carolina residential real estate sale, the buyer and seller enter into a form contract and the buyer hires an attorney to conduct a "closing." *See* Webster's Real Estate Law in North Carolina §§ 9-5 and 9-24 (5th ed. 2007). The form contract requires the seller to deliver a fee simple, marketable title and requires the buyer to deliver the purchase price in cash at closing, unless otherwise agreed in the contract itself. (R. pp. 70-74, ¶¶ 4 and 5) The parties in the instant case followed the customary model. (R. pp. 70-74)

To facilitate the exchange of the purchase price for the deed to the property, the buyer typically deposits the contract price, including both the buyer's funds and any loan proceeds from a mortgage lender, with the buyer's lawyer at or just before the closing. The seller typically provides an executed deed to the property to the buyer's lawyer for delivery to the buyer upon the buyer's payment of the purchase price. *See* Webster's Real Estate Law in North Carolina § 10-54 (5th ed. 2007).

Under North Carolina law, the buyer's lawyer may not disburse the sale proceeds until recordation of the deed and the deed of trust. N.C. Gen. Stat. § 45A-4 (2007). Accordingly, the lawyer records the deed and deed of trust immediately after closing. Only then can the lawyer disburse the funds to pay the parties' closing costs, clear the seller's liens, and pay the seller the net sale proceeds. The lawyer usually makes these payments by uncertified checks drawn on the trust account.

B. WHEN DOES THE SELLER CONVEY TITLE?

Under North Carolina law, a seller conveys title to property to the buyer only upon delivery of a deed. *See Williams v. N.C. State Bd. of Educ.*, 284 N.C. 588, 201 S.E.2d 889 (1974). The deed is delivered only when the seller intends delivery. *See* Webster's Real Estate Law in North Carolina § 10-54 (5th ed. 2007). Until the buyer satisfies all conditions, title remains with the seller. *See Craddock v. Barnes*, 142 N.C. 89, 54 S.E. 1003 (1906). The seller's delivery of the deed is

conditional upon receipt of the purchase price from the buyer. *See* Webster's Real Estate Law in North Carolina § 10-54 (5th ed. 2007).

Under the typical form contract, transfer of title to the buyer is not complete until the buyer has paid the consideration in cash.[1] Tender of a non-certified check by a buyer or his agent is not payment in cash and does not satisfy the underlying obligation to pay the money due. If the check is returned by the bank on which it is drawn for insufficient funds, the buyer has not satisfied the condition and the seller has not been paid. *See* N.C. Gen. Stat. § 25-3-210 (2007).

C. THE ROLE OF THE CLOSING ATTORNEY.

A lawyer is normally considered an agent for the party by whom he or she is engaged. *See*, Restatement (Third) of the Law Governing Lawyers § 16 (2000). In the typical residential real estate closing, the buyer selects the closing lawyer. While the buyer's lawyer may prepare the deed and other seller documents as an accommodation to the seller, he or she is still acting as the buyer's agent. *See* North Carolina State Bar Formal Ethics Opinion 04 FEO 10 (2005).

As the buyer's agent for the collection and disbursement of funds, the closing lawyer has a duty to the buyer and the lender to maintain the funds and

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[1] While recordation of the deed gives notice to third parties of the transfer, it does not affect the validity of the deed between buyer and seller. *See* Webster's Real Estate Law in North Carolina § 10-55 (5th ed. 2007). Accordingly, even an invalid deed may be recorded if there is a failure of consideration by the buyer.

render a full accounting for them. *See* Restatement (Third) of the Law of Agency § 8.12 (2006); N.C. Revised Rules of Prof' Conduct, R. 1.15-2 and 3. The lawyer's duty is to account to the clients, the buyer and the lender, not to third parties. *See*, N.C. Revised Rules of Prof' Conduct, R. 1.15-2. Nothing in the role of the lawyer indicates that the seller places any confidence in the lawyer as his or her agent for payment of the proceeds.

D. IS THE EXCHANGE OF PAYMENT FOR TITLE AT CLOSING AN ESCROW?

Parties to a typical real estate closing anticipate that there will be a virtually simultaneous exchange of title for the payment of the sales price at a closing. This is not an escrow, but a conditional delivery. The seller provides the deed to the closing lawyer at or just before the closing with instructions that it is to be delivered to the buyer upon the seller's receipt of the buyer's funds for the sales price. This does not create an escrow. *See McMahan v. Hensley*, 178 N.C. 587, 101 S.E. 210 (1919); Webster's Real Estate Law in North Carolina § 10-53 (5th ed. 2007).

Because the closing transaction is not an escrow, *Avent* simply does not apply. Instead, the buyer is responsible, as principal, for any loss caused by the buyer's agent. *See* Restatement (Third) of the Law of Agency § 6.01 (2006).

E. WOULD *AVENT* APPLY EVEN IF THE TRANSACTION WERE AN ESCROW?

Even if the North Carolina model for closing residential real estate transactions could properly be considered an escrow arrangement, the *Avent* decision does not control. *Avent* did not involve a "deed and money" escrow, but rather, a "set-aside" escrow. *See Bixby Ranch Co. v. United States*, 35 Fed. Cl. 674 (1996). The "deed and money" escrow describes the deposit of the buyer's funds and the seller's deed with an agent pending the satisfaction of the conditions of sale. *Id.* The "deed and money" escrow is the only escrow that could apply to the typical North Carolina closing.

Avent must be viewed in the context of a "set-aside" escrow. *Id.* The "set-aside" escrow involves the escrow agent continuing to hold funds after closing pending the seller's satisfaction of a post-closing condition or paid directly to satisfy an obligation of the seller after closing. *Id.* at 680. The "set aside" escrow in *Avent* is significantly different than that presented in the typical closing.

In an ordinary escrow, any loss of the escrowed property caused by the escrow agent falls upon the party who made the deposit into the escrow. *See Craddock v. Cooper*, 123 So. 2d 256 (Fla. Dist. Ct. App. 1960). In the "set-aside" escrow, the courts treat the held funds as funds deposited in escrow by the seller because the buyer no longer has any right to the funds. *See Bixby Ranch*, 35 Fed. Cl. at 680. Thus, the *Avent* case is distinguishable from the common closing

because the attorney in *Avent* was no longer acting as the buyer's agent, but as authorized holder of the seller's funds.

F. "ENTITLEMENT" TO THE FUNDS IS NOT THE SOLE FACTOR IN DETERMINING THE EQUITIES OF THE PARTIES.

The determination of which of two parties should suffer a loss caused by a third party is an equitable decision that requires an analysis of all of the circumstances. Relying solely on "entitlement" to determine which party suffers the loss does not resolve the question because it is not always clear who was "entitled" to the funds at the time of embezzlement. A lawyer might have embezzled a previous client's funds before the current closing and written several outstanding checks, all of which are now competing to be paid by new funds deposited by a new buyer-client. If the outstanding checks exceed the new funds deposited into the trust account for the new client, it would be very difficult to determine when the new client's funds were actually stolen. Banks do not segregate deposits and payments by payee within a commingled trust account. The newly deposited funds at a closing are immediately available to pay any prior outstanding checks, not just those issued at the closing. There must be sufficient aggregate funds on deposit to cover all checks presented on the banking day of presentment, whether or not the balance at the beginning of that day may have been sufficient to cover a specific check. If the aggregate funds are insufficient,

the bank pays those items it can and returns the other checks for insufficient funds. *See* N.C. Gen. Stat. § 25-4-201 *et seq.* (2007).

Accordingly, the beginning and ending daily bank balances are not evidence of whether any particular check presented for payment will be paid when there are multiple checks competing for the same funds. The fact that there may be sufficient funds in the account to pay an item at one particular moment, but not the next, places the seller in the untenable position of having to race to the closing lawyer's bank to present the check in exchange for currency at the exact time the funds are available. If the seller deposits the check into his own bank account, as one would expect the seller to do, rather than presenting it directly at the closing lawyer's bank for currency, the seller is still not paid until the lawyer's bank pays the seller's bank, a process that may take days. *See* N.C. Gen. Stat. § 25-4-201 *et seq.* (2007).

Determining the moment of embezzlement is further complicated because the banking day begins and ends at 2:00 pm. Any deposits made and checks presented to a bank after 2:00 pm are considered transactions for the next day. N.C. Gen. Stat. § 25-4-107 (2007). A deposit of funds to a lawyer's trust account at either 2:01 pm or 4:45 pm on January 3 is treated by the bank as a deposit on January 4. N.C. Gen. Stat. § 25-4-107 (2007). Therefore, any closing held after

2:00 pm will have a different banking day than the actual calendar date of the closing.

II. LENDERS AND BUYERS CAN INSURE AGAINST THE RISK OF EMBEZZLEMENT BY OBTAINING CLOSING PROTECTION LETTERS FROM TITLE INSURERS.

The equitable maxims applied in *Avent* and other cases allocating loss between two innocent parties caused by a third party are premised on the notion that the parties have not agreed upon an allocation of the risk or insured against the risk in advance. *See* Flores, *A Comparison of the Rules and Rationales for Allocating Risks Arising in Realty Sales Using Executory Sale Contracts and Escrows,* 59 Mo. L. Rev. 307 (1994). In North Carolina, lenders (and buyers through their lenders) can and typically do insure against the risk of embezzlement or other fraud or dishonesty by the closing attorney.

In North Carolina, a lender who requires title insurance for a residential real estate transaction to protect the title from potential claims against its security interest receives a "closing protection letter" (sometimes called an "insured closing letter") that protects the lender and the buyer/borrower against dishonest conduct by the closing lawyer. Title insurance companies, through the North Carolina Land Title Association, have filed a uniform closing protection letter with the North Carolina Rate Bureau. The uniform closing protection letter insures the lender and the buyer from, among other matters,

> "[f]raud, dishonesty, or negligence of the Issuing Agent or Approved Attorney in handling your funds or documents in connection with such closings to the extent such fraud or dishonesty relates to the status of the title to said interest in land or to the validity, enforceability, and priority of the lien of said mortgage on said interest in land."

ALTA Closing Protection Letter, N.C. Dept. of Ins. No. 20071201737, effective January 1, 2008, found on the internet at http://infoportal.ncdoi.net/getfile.jsp?sfp=/PC/PC111000/PC111599A954730.PDF.

[2] The risks insured in this letter are the very risks caused by a closing lawyer's embezzlement of funds deposited by or for the buyer for payment of the purchase price. This coverage is available only to lenders and buyers. Closing protection letters do not protect sellers and cannot be purchased by sellers. It follows, therefore, that as a part of the routine residential real estate transaction, the parties have already allocated the risk of loss to the buyer.

Presently in North Carolina, the only recourse available to a seller for failure of the closing attorney to pay the proceeds, other than rescission of the deed or the contract for failure of consideration, is an application for reimbursement by the State Bar's Client Security Fund.[3] If this Court were to adopt a rule providing that

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[2] This is the current version of the uniform closing protection letter. Prior versions of the letter had essentially the same language.

[3] Reimbursement by the Client Security Fund is not an option when insurance is available to cover the loss. See, 27 N.C. Admin Code, Ch. 1, Sub. D § .1401(b)(8) (2008).

the seller bears the risk of loss, the first source of possible reimbursement, rescission of the transaction, would no longer exist. The seller would then have recourse only by filing a claim with the Client Security Fund. The Client Security Fund is not an insurance program. It is a fund of last resort. No claimant has a right to reimbursement. Any reimbursement that is made is limited to $100,000 per claim. 27 N.C. Admin. Code, Ch. 1, Sub D § .1400 et seq (2008). Given that the sales price of the average North Carolina home likely exceeds $100,000, the $100,000 which might be available from the Client Security Fund would often be inadequate to make a seller whole.[4]

Allocation of the risk of loss between innocent parties is an equitable consideration based on the facts and circumstances. Some courts have also allocated the risk of loss based on who is the "least" innocent party. *See* Flores, *supra*. By selecting the closing lawyer and insuring against the risk, the buyer at least had some say in who would be handling the funds. Title insurers only issue closing protection letters covering closings performed by lawyers on their lists of approved closing lawyers. Title insurers have either evaluated the lawyers on those lists or at least had a full opportunity to do so. The buyer and the lender,

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[4] For example, the US Census Bureau reports that the median value of a home in the Charlotte geographic area in 2002 was $125,551. American Housing Survey for the Charlotte Metropolitan Area 2002 at 25 (2003) available on the internet at http://www.census.gov/prod/2003pubs/h170-02-63.pdf.

although not blameworthy, are not the "least" innocent parties. The seller had no say in the decision at all.

Finally, before extending *Avent* to cover typical closings, the State Bar asks the Court to consider the impact on routine closings. Such a rule would shift the risk to the only party with no effective means of protection, the seller. To protect themselves under such a rule, sellers would have no alternative but to demand payment to themselves only in currency or by official bank check. Lenders typically wire loan proceeds into the lawyer's trust account immediately before closing. Banks are unlikely to provide official bank checks for hundreds of thousands of dollars on a moment's notice. It is not feasible for sellers to demand payment of hundreds of thousands of dollars in currency. While it is theoretically possible for title insurance companies to extend closing protection letters to sellers, they have not done so in North Carolina. Expanding *Avent* to cover typical closings would allow a lawyer to shift the risk of loss caused by his theft from his clients to a stranger simply by delivering a check against insufficient funds.

CONCLUSION

For the reasons set forth above, the State Bar urges this Court to limit the application of *Avent* to post-closing "set aside" escrows and to allocate the risk that the purchase price will be embezzled to the parties who selected the lawyer, the buyer and the lender.

Respectfully submitted, this the 17th day of June, 2008.

Amicus Curiae -- The North Carolina State Bar

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CERTIFICATE OF COMPLIANCE WITH N.C. APP. R. 28(j)

1. I hereby certify that this Brief complies with the type-volume limitations of N.C. App. R. 28(j)(2)(A)2 because this Brief contains fewer than 3750 words (3568 by automated count including footnotes), excluding the parts of the Brief exempted by N.C. App. R. 28(j)(2)(A)2.

2. I hereby certify that this Brief complies with the typeface and typestyle requirements of NC App. R. 28(j)(1)(A) and N.C. App. R. 28(j)(1)(B)2 because this Brief has been prepared using a 14 point Times New Roman proportionally space typeface.

This 17th day of June, 2008.

David R. Johnson, Deputy Counsel
The North Carolina State Bar
Amicus Curiae

CERTIFICATE OF SERVICE

The undersigned hereby certifies that the foregoing Brief as Amicus Curiae was served upon the Appellants and Appellees by depositing a copy of the same in the U.S. Mail in a postage prepaid envelope addressed as follows:

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This the 17th day of June, 2008.

David R. Johnson, Deputy Counsel
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Amicus Curiae

No. COA08-133

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F.S.B.,
Defendants.

From Johnston
(06CVS2148)

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ORDER

The following order was entered:

The motion filed in this cause on the 17th day of June 2008 and designated "Motion of the North Carolina State Bar for Leave to File Brief as Amicus Curiae" is allowed.

By order of the Court this the 20th day of June 2008.

Witness my hand and official seal this the 20th day of June 2008.

John H. Connell
Clerk of North Carolina Court of Appeals

cc:
Ms. Katherine Jean
Mr. David R. Johnson
Mr. Gordon C. Woodruff
Mr. James K. Pendergrass, Jr.

FILED THE 20TH DAY OF JUNE 2008 AT 11:08 AM IN THE OFFICE OF THE CLERK, COURT OF APPEALS OF NORTH CAROLINA