

ESCROW FUNDS: WHOSE PROPERTY?

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At a real estate closing, title companies typically escrow funds to satisfy various outstanding obligations of a buyer or seller (or in the context of a refinancing, the owner of the property). These outstanding obligations, most commonly tax liens, mechanic's liens and judgments, would otherwise be deemed an "exception" to title coverage. Title companies then use the funds being escrowed (the "Escrow

Funds") to satisfy these outstanding obligations, and "omit" these obligations from the "exceptions to coverage" section (schedule B) of the title policy. By omitting the exception to coverage, the title company insures over the subject outstanding exceptions.

As a general practice, to accommodate their clients (the buyer, seller or owner), title companies often place the Escrow Funds into interest bearing bank accounts. These accounts are typically identified by the client's name and the client's federal tax identification number, or social security number. This accommodation permits the title company's client to receive the accrued interest on the Escrow Funds.

But what happens when a judgment creditor of the client endeavors to attach the Escrow Funds before the title company is able to satisfy the outstanding obligation it has insured? The title company can be forced into an awkward dilemma. On the one hand, it has accepted the liability of the title "exception" (by omitting it from the schedule of title exceptions), on the other hand it may lose access to the very funds that were escrowed to satisfy the outstanding exception that it is now insuring. In this event, if the judgment creditor successfully attaches the bank account, a title company must choose between two distasteful alternative courses of action: suing its client to replenish the Escrow Funds (which brings with it obvious negative customer relations issues), or, on behalf of its client, engage in a legal battle with the judgment creditor over entitlement to the Escrow Funds.

This article will outline the legal issues that title companies face, the applicable substantive and procedural law and make suggestions as to what title companies can do when escrowing such funds to avoid attachment by third party creditors while maintaining good client relations.

THE SCENARIO

Assume the following facts: In connection with a real estate closing on February 15, 2000, a deposit and escrow agreement is entered into between: (i) the building owner, John Owner; and (ii) ABC Title Company, pursuant to which Escrow Funds are deposited with ABC Title Company to hold and use to cure and ultimately remove an outstanding exception and clear title. The escrow agreement states that the Escrow Funds are to be held in an interest bearing account.

After the closing, ABC Title opens a bank account at XYZ Bank and identifies the account holder as "John Owner, social security number 123-45-6789." However, the only signatory on the account is ABC Title Company because the only party intended to have possession and use of the Escrow Funds is ABC Title Company.

On March 15, 2000, Samantha Creditor, an unrelated third party, procures a judgment against Mr. Owner and thereafter seeks to enforce her judgment. Through information subpoenas, she discovers the account at XYZ Bank in Owner's name and serves a restraining notice upon the bank. Despite the fact that ABC Title opened the account, and that it is the sole signatory on the account, banks typically take the position that because Mr. Owner's federal tax identification number was used in connection with opening the account, the monies on deposit belong to Mr. Owner. Therefore, presumably XYZ Bank will obey the restraining notice and pay the amount remaining in the account over to the judgment creditor.

The bank's position is not without merit. Case law interprets section 5209 of the Civil Practice Law and Rules ("CPLR") as providing a bank with immunity from liability when it pays out according to an execution where a judgment creditor has specified certain property of the judgment debtor as being subject to levy. *Chin v. Riggs Nat'l Bank*, 670 N.Y.S.2d 187 (1st Dep't 1998) (Garnishee's compliance with CPLR 5209 is a safe harbor that pre-empts the judgment debtor's common law claim that the garnishee should have investigated the validity of the execution).

On the other hand, ABC Title contends that the designation of Mr. Owner as the named account holder and the use of his social security number were done solely for convenience purposes and to clarify that the interest earned on the escrow funds would be taxable solely to Mr. Owner, not to the title company.

(continued on next page)

ESCROW FUNDS: WHOSE PROPERTY?

(continued from previous page)

SPECIAL PROCEEDINGS UNDER CPLR 5239

Because XYZ Bank is likely to be immune from liability should it pay out the Escrow Funds as directed by a valid execution, the most appropriate and most expedient remedy for the title company involves the commencement of a special proceeding to determine adverse claims to the Escrow Funds on deposit at the bank. Such a special proceeding is the procedure authorized under CPLR 5239. CPLR 5239 states in relevant part that:

Prior to the application of property or debt by a Sheriff or receiver to the satisfaction of a judgment, any interested person may commence a special proceeding against the judgment creditor or other person with whom a dispute exists to determine rights in the property or debt.

Special proceedings are relatively speedy and abbreviated (though not inexpensive) court proceedings sanctioned by Article 4 of the CPLR. A notice of petition, petition and answer, take the place of formal pleadings. Typically, the proceedings are commenced by way of an order to show cause, particularly where a temporary restraining order (“TRO”) is required in order to preserve the status quo of the Escrow Funds while the ultimate rights to relief are litigated. A TRO request, pursuant to CPLR 6313, would seek to restrain the bank from paying out the Escrow Funds to the judgment creditor. In order to secure the TRO, however, a bond will need to be filed with the order to show cause. Additionally, in order to have the bonding company waive a collateral deposit, the bonding company normally requires a copy of the title company’s certified financial statement or annual report to satisfy its underwriting requirements. Since the bond premium and the financial statement or annual report need to be delivered to the bonding company at least 24 to 48 hours before the TRO is requested, the application for the TRO bond should begin promptly.

The venue for a special proceeding is dictated, under CPLR 5239, to be those counties specified under CPLR 5221(a). The venue provisions involved are mandatory and can lead to dismissal if not strictly followed. In *re Sharon Towers, Inc.*, 673 N.Y.S.2d 138 (1st Dep’t 1998).

The ultimate success of the special proceeding under CPLR 5239 depends upon the title company’s ability to convince the court that the Escrow Funds are not subject to the control of the client (the named account holder), and that the special purpose for which those funds were deposited still exists, that is, the

satisfaction of the client’s outstanding title exception.

The factual presentation in support of the application for the special proceeding will need to include an affidavit attesting to the special purpose for which the escrow account was established, and that the title company is the sole signatory upon the escrow account and the client has no ability or legal right to withdraw or direct the disposition of funds in the account. Copies of account cards, applications and bank statements reflecting the account signatories should be produced as exhibits. Also, perhaps the most relevant evidence of the title company’s superior right to the Escrow Funds is the escrow agreement (the “Agreement”) itself. Some title company escrow agreements, for example, may provide a specific purpose for which the Escrow Funds are to be used by the depository, the title company.

To the extent that the client retains any interest in the Escrow Funds over and above the amount necessary to actually and ultimately satisfy or discharge the outstanding obligation, such excess does constitute the client’s property and will be subject to levy and garnishment.

THE APPLICABLE LAW

The title company’s request for relief is supported by *Rafkind v. Chase Manhattan Bank*, 1992 WL 380291 (S.D.N.Y. 1992). In *Rafkind*, the Court summarized the applicable law as follows:

“A judgment debtor may contract with a third party to withhold funds to which the judgment debtor would otherwise be entitled, for purpose of paying certain of the judgment debtor’s creditors. See *M.F. Hickey*, 258 N.Y.S.2d at 130 (1st Dept. 1965). Once the judgment debtor has contracted away his rights to funds to pay certain creditors, his interest in the funds is limited to the funds remaining after such creditors are paid. *Id.* (citing *United States Fidelity & Guaranty Co. v. Triborough Bridge Auth.*, 297 N.Y. 31, 37, 74 N.E.2d 226 (1947)). Any subsequent judgment creditor has only a contingent interest in the funds that vests only if there is a surplus after paying the other creditors. See *M.F. Hickey*, 258 N.Y.S.2d at 130; see also *U.R.C. Inc. v. Applied Images, Inc.*, 106 Misc.2d 1034, 1040, 431 N.Y.S.2d 859, 862 (Sup. Ct. 1980) (citing *M.F. Hickey*); *United States v. Sterling Nat’l Bank and Trust Co.*, 494 F.2d 919, 922 (2d Cir. 1974) (citing *United States v. Hampton Garment Co.*, 71-1 U.S. Tax Case 9357 (S.D.N.Y. 1971).

In so holding, the *Rafkind* court relied in part upon *M.F. Hickey, v. Port of New York Authority*, 258 N.Y.S. 2d 129 (1st Dept.

(continued on next page)

ESCROW FUNDS: WHOSE PROPERTY?

(continued from previous page)

1965), where the Appellate Division, First Department, found that a contractor had an “interest, albeit a contingent one, in the withheld fund, and this interest will vest if any surplus remains after the payment of all just claims. . . . Consequently, the judgment creditor was entitled to a declaration that it will be entitled to recover any such surplus as may remain.” *Id.* At 130.

Other cases also support the relief requested in the special proceeding. For example, *U.R.C. Inc. v. Applied Images, Inc.*, 431 N.Y.S.2d 859 (Sup. Ct. Nassau Co. 1980) has been widely followed in New York State. Distilled to its legal significance, *U.R.C.* holds that traditional escrow or collateral deposits should be considered exempt from execution, except for any “excess” over the balance due to the party which established the escrow fund for security purposes.

Other courts have followed and applied the authorities collected in *U.R.C.* in analogous situations where funds or property were placed for security or collateral purposes. In each instance, the controlling and determining factor appears to be that the property in issue must be dedicated to a specific bona fide purpose and placed beyond the ability of the judgment debtor to control or assign such property. *American Federal Group Ltd. v. Rothenberg*, 1998 WL 273034 (S.D.N.Y. 1998) (defendant had no power to assign or transfer appeal bond or letter of credit securing it, therefore, plaintiff could not attach either asset).

SECURITY INTEREST

The title company can and should claim that it holds a pledge of and security interest in the bank account which was specifically set up to be an escrow account in connection with a single transaction. Typical title company escrow agreements include language to the effect that in consideration of its obligations under the Agreement, the client-Depositor assigns (and preferably “pledges”) to the title company a security interest in the Escrow Funds “superior to all other liens and claims.” This provision would satisfy the traditional requirement that in order for a security interest to arise, the secured party must produce a written agreement by which the debtor grants the secured party a security interest in certain identified property.

In addition, however, the secured party must “perfect” its security interest. In this case, the filing of a UCC-1 Financing Statement is not required, as Section 9-104 of the Uniform Commercial Code (“UCC”), expressly excludes “deposit accounts” from the scope of Article 9. Perfection of a security interest in property

outside of Article 9 of the UCC therefore requires that the secured party take possession of the collateral and exercise dominion and control over the collateral to the exclusion of the debtor. For example, a passbook savings account would typically be pledged by delivery of the passbook and a power of attorney to sign on the account of the debtor to the secured party, thereby removing the debtor’s ability to access the bank account without the passbook, and giving the secured party exclusive possession and dominion.

Escrow accounts related to title policies typically will not lend themselves to the convenience and certainty of a “passbook” type pledge. Instead, a master account with individual sub-escrow accounts for each individual client are typical with commercial banks. Usually, the sub-accounts will carry account names such as “ABC Title Company f/b/o John Owner” and carry the corresponding Social Security or tax identification number of John Owner. As a practical matter the title company needs to use the client’s name and Social Security number on the sub-account in order to accurately account for and report interest income accruing on the escrow deposit. However, these practical necessities associated with tax reporting requirements also present an inviting target for the judgment creditor’s information subpoena, restraining notice, or execution. Collection firms often will blanket all financial institutions in a specific area with information subpoenas and restraining notices containing the judgment creditor’s name and tax identification number, knowing that most banks have a so-called “liens and levies” unit which will attempt to match the creditor’s information against the bank’s computer record of account names and tax identification numbers. A computer match or “hit” will generally cause an automatic restraint on the account.

Fortunately, most banks provide notice to account holders of any restraint or levy, thereby perhaps allowing the title company an attempt at convincing the judgment creditor to voluntarily withdraw the restraint. However, since the escrow account may (and usually does) contain additional security by way of funds potentially in excess of the amount that will actually prove necessary to cure any insured title exceptions, voluntary dismissal of the escrow restraint by the judgment creditor may prove problematic.

It would be wise to produce proof in any special proceeding that the account in question: (i) was established by the title company for payment of specific debts; (ii) was solely within the control of the title company; and (iii) that such funds were segregated funds pledged for a particular purpose. If proven, these facts

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ESCROW FUNDS: WHOSE PROPERTY?

(continued from previous page)

would enable the title company to make a convincing argument that it had established a common law lien and security interest in the Escrow Funds that comprise the portion of the escrow account necessary to satisfy the subject outstanding obligation.

It is important to anticipate, however, that a judgment creditor might argue that under UCC Section 9-305, a security interest in “money” was not adequately perfected due to the ambiguous designation placed upon the bank account by the title company of the client’s name and the use of the client’s federal tax identification number on the account. But UCC 9-305 allows a security interest in “money” to be perfected by possession.

A practical way a party can “possess” the Escrow Funds is by depositing them in a bank account which is carried in the name of the secured party (i.e., the ABC Title Company of earlier hypothetical). Under proposed revisions in UCC 9-109, one way for a secured party to “control” a deposit account is to be named as the bank’s “customer” on the account. However, common law precedents in this area of security interests in bank accounts are not entirely clear or uniform. For example, in *Miller v. Wells Fargo Bank*, 540 F.2d 548, 560-63 (2d Cir. 1976), the Court rejected a pledge where the account was solely in the name of the debtor and no “indispensable instrument” was issued to the secured party to control the account, such as a passbook. However, the signature cards to the account and reliance upon the doctrine set forth in *M.F. Hickey Co.*, supra., should permit the title company to prevail, assuming that the ambiguous title to the bank account can be clarified by showing the title company as the exclusive signatory on the account and by showing the exclusion of any right in the client to transfer or assign those monies.[1] Although UCC 9-305 allows an interest in money to be perfected by possession, UCC-9-104 excludes “deposit accounts” from the scope of the filing requirements of Article 9. Therefore, the filing of a UCC-1 financing statement is not necessary or effective even under the revised Article 9 (the only exception being Certificate of Deposit under the revised UCC sections 9-311(a) and 9-310(a)).

CONCLUSIONS AND PRACTICAL SUGGESTIONS

The dispositive test should be whether the client has the right to direct the disposition of funds contained in the escrow account. Once the Escrow Funds have been attached by a judgment creditor, commencing a special proceeding is the only viable means to protect the Escrow Funds.

Practical suggestions to assist a title company in this context include:

(i) A title company’s deposit and escrow agreement should clearly recite the purpose for which the escrow funds are being used, and that it has a superior right to the funds over all other liens and claims, whether contingent or otherwise. It may also recite that the designation of the client and the client’s federal tax identification number is for the sole purpose of assigning accrued interest to the client and that the client has no rights in the underlying Escrow Funds until the obligation is satisfied;

(ii) The deposit and escrow agreement should also be specifically entitled as a security agreement (e.g., “Deposit, Escrow and Security Agreement.”) In addition to specifically granting (not merely assigning) the title company a paramount security interest in the escrow deposit, the Agreement should recite that the actual amount which will be needed to cure the title defect is not capable of being precisely known until the defect is actually removed. Therefore, the title company’s security interest extends to all funds on deposit, to be held as collateral security against additional costs, legal fees and the uncertainties inherent in clearing a clouded title; and

(iii) Given the foregoing, title companies should seriously consider using non-interest bearing accounts for small escrow amounts or where the escrow is short-term. In this way, by depositing the funds in one of their segregated accounts, with no reference to the client, they can avoid the attachment problem.

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1. Under the pending revisions to UCC Article 9 and UCC § 9-203(a)(1), security interests in “deposit accounts” are enforceable if: (i) the secured party has “control” pursuant to the debtor’s agreement; or (ii) the debtor has signed a security agreement that contains a description of the collateral
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