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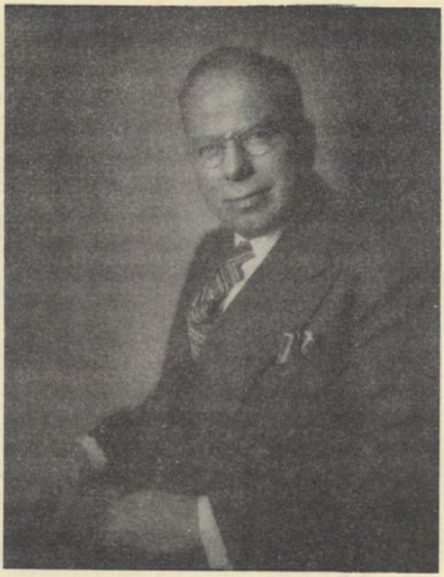

Milton P. Kupfer

To Mr. Kupfer, we express our thanks for authorizing the reproduction of his excellent article in "Title News."

To the New York State Bar Association and its Journal, we express our thanks for their gracious courtesy in permitting use of the article in our publication.

THE RECENT AMENDMENT TO THE PREFERENCE SECTION OF THE BANKRUPTCY ACT

by

MILTON P. KUPFER

Mr. Kupfer's address was delivered at the 1950 annual meeting of the Banking Law Section, New York State Bar Association. The author is a member of the New York State Bar Association; Chairman of the American Bar Association's Division of Reorganization and Bankruptcy, and of the Committee on Bankruptcy and Corporate Reorganizations of the Bar Association of the City of New York. -Ed.

I can only hope that my remarks will not place me in the position of the law clerk of the large Boston firm,one of whose senior partners instructed him to go to the home of a recently deceased client and make an inventory of its contents.It seems that the client was a wealthy old recluse, and, when the budding young advocate entered the house, the first object that caught his eye was a two-gallon whiskey jug, filled to the brim with the elixir of life. Accordingly, he dutifully wrote down "1 Two-gallon Jug of Whiskey." Not hearing from the boy for three or four hours, his employer became worried; went to the house; and, when he entered, found the young advocate on the floor dead to the world and in a rather emphatic state of disrepair. Along-side of him was the memorandum-inventory, with the word "Empty" written alongside the reference to the jug, and with the words "1 Revolving Rug" immediately beneath it. If, in the course of my remarks, I, too, succeed in emptying the jug, I trust that I will not lead all of you on to a revolving rug.

In this presence, one would have to be both naive and presuming to enter into any horn-book discussion of the meaning or effect of a preference in bankruptcy. You know as much, if not more, about it than I do. Therefore, the only justification for the gracious invitation of your Program Committee for my appearance before you is that, with many others of like mind, I happen to have been concerned in the recent remediation of its most throbbing headache and it is to the accomplishment of that endeavor that I shall address myself.

This paper will treat of the difficulties with the interpretation of Section 60 (the preference Section) of the Bankruptcy Act over the past decade, and their cure, along the following lines:-

> (a) by way of introduction, a brief outline of the history of the section, particularly in the light of the cases decided in the earlier decades of the century; the unfortunate interpretation, from the standpoint of general creditors, which those cases placed upon it; and the abortive amendments of 1903, 1910, and 1926;
>
> (b) the radical 1938 amendment and the equally unfortunate and unanticipated consequences, from the standpoint of secured creditors which followed in its wake as the result of its interpretation in the case of Klauder v. Corn Exchange National Bank & Trust Company (1943) (318 U.S. 434); and
>
> (c) finally, the redress of the balance, and, we trust, the cure of the entire situation by the amendment to Section 60-a, embodied in P.L. 461 of the current (81st) Congress.

I

As you know, Section 60-a defines a preference, and Section 60-b provides for its avoidance. Between them, they prescribe 7 elements of a preference, all of which must be present to make it avoidable by a trustee in bankruptcy. Six of the elements are set forth in Section 60-a; the seventh in Section 60-b; but, in order to understand the aggregate, both sections must be read together.

Section 60-a defines a preference as (1) the bankrupt's making or suffering a transfer of his property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt; (4) while insolvent; (5) within four months of the filing of the petition; and (6) the effect of which transfer will be to enable the creditor to obtain a greater percentage of his debt than some other creditor of the same class.

Section 60-b then provides: (7) that such a preference may be avoided by the trustee upon proof of the additional element that the creditor receiving the preference had reasonable cause to believe that the debtor was insolvent.

Each of these elements except the sixth (which is determined in the light of the actual results of bankruptcy) relate to a single, crucial point of time--namely, when the transfer was "made or suffered." It is the attempt to define and fix this time-element in the light of the respective equities of secured and unsecured creditors that is at the root of all of the trouble that, for fifty years, has attended the substantive interpretation and procedural administration of the law of preference.

After the enactment of the Bankruptcy Act of 1898, the narrow and literal judicial interpretation of Section 60 in the earlier years of the century resulted in the creation of two loopholes through which creditors, actually prefered, were permitted to slip. One of them was the protection that the courts accorded so-called equitable liens, and the other was their frequent disregard of the policy of state recording statutes.

Accordingly, as early as 1903, subdivision a was amended, so as to provide for the postponement of the running of the four months' period until transfers were recorded, where, by state law, recording was "required." Congress thus attempted to fix a fictitious point of time for the determination of the question of whether a preferential transfer had been made. Thus it was hoped that, if a transfer was made by way of an unrecorded mortgage or an uncompleted pledge six months prior to bankruptcy, and the mortgage or pledge was recorded or possession taken within four months of bankruptcy, the date of recording and not the original date of the transaction would be deemed the time of transfer.

The 1903 amendment effected little change in judicial interpretation. Accordingly, in the hope of proscribing secret transfers, still held invulnerable by the courts against a trustee's attack, the 1926 amendment--after a further abortive attempt in 1910--added the words "or permitted" to the last sentence of Section 60-a, so that the prescribed period of four months would not expire "until four months after the date of recording or registering of the transfer if by law such recording or registering is required or permitted". However, since a corresponding amendment was not made in Section 60-b (the enforcement subsection), it was held that only those transfers within the four months' period, which the law required to be recorded as against creditors, could be set aside. This, according to a recognized authority (3 Collier on Bankruptcy, 767) "introduced an element of inconsistency into Section 60-a and only served to thicken rather than to dispel the fog".

The state of the law prior to the 1938 amendment can best be illustrated by the lines of so-called

> (a) "pocket-lien" cases of Carey v. Donohue (1916) 240 U.S. 430, Bailey v. Baker Ice Machine Co. (1915) 239 U.S. 268, Martin V. Commercial National Bank (1918) 245 U. S. 513, Bunch v. Maloney (1918) 246 U.S. 658, and (b) "relation-back", or equitable lien, cases of Thompson v. Fairbanks (1905) 196 U. S. 516, Humphrey v. Tatman (1905) 198 U.S. 91, Sexton v. Kessler (1912) 225 U.S. 90.

In Carey v. Donohue, the trustee sought to set aside a real estate transfer, executed more than four months before bankruptcy but not recorded until the four months' period had commenced to run, and at a time when the transferor was insolvent. The Ohio recording statute protected only bona fide purchasers, but recording in that state was not essential to the validity of a conveyance, either absolute or as security, as against general lien, or judgment creditors. The United States Supreme Court held that, since creditors were the only class of persons represented by a trustee in bankruptcy and recording was not required as against them, the non-recording of the deed prior to the beginning of the four months' period did not render the transaction subject to avoidance as a preference.

Turning to the personal property field, Bailey v. Baker Ice Machine Co. and Martin v. Commercial National Bank were almost identical on their facts, except that the first involved a conditional sale contract and the second a chattel mortgage. As illustrative of both, in the Martin case, one Virgin (a resident of Georgia), on February 16th, executed and delivered a mortgage upon his stock of merchandise as security for money loaned to him by a bank. The mortgage was not recorded until the following August 20th, when the bank knew of Virgin's then insolvency. In fact, involuntary bankruptcy proceedings were instituted against him on the following day. The Georgia recording statute imposed the requirement of recording only in favor of a creditor who fixes a lien on the property before recording takes place. For this reason, following the Carey v. Donohue case, the Supreme Court held the transaction non-preferential.

In all of these cases, the court also held that the so-called "strong arm" provision of Section 70-c did not avail the trustee, because in none of them did there exist a creditor who, prior to recording, had acquired a lien by attachment or execution. Generally speaking, the net of these holdings was that if, as was most unusual, the state law made the transaction voidable by general creditors, failure to record until after the beginning of the four months' period made the transaction preferential, but, if it did not, there was no preference merely because the debtor was insolvent at the time of recording, even if recording took place, as in the Martin case, the day before the filing of the bankruptcy petition.

The "relation-back", or equitable lien, cases of Thompson v. Fairbanks; Humphrey v. Tatman; and Sexton v. Kessler, did not involve recording statutes, but so-called equitable liens, conferred prior to the beginning of the four months' period or at a time when the Debtor was not insolvent, but which did not attain the perfection of legal liens until the four months' period had commenced to run and factual insolvency had supervened. Of these cases, Sexton v. Kessler, which was the last and which went to the verge, is typical. There, before the beginning of the four months' period, a New York debtor purported to "pledge" certain specifically identified stocks and bonds with the creditor, an English corporation. The securities, however, remained in the debtor's safe deposit box in New York and under his control. They were not delivered to the creditor until within four months' period, and at a time when the debtor, to the creditor's knowledge, was concededly insolvent. The United States Supreme Court held that, under the applicable state law, there was an equitable lien from the beginning; that the delivery, which effected a legal lien, "related back" to the date of the original transaction; and that the trustee could not recover the securities as preferentially transferred.

It was also held in subsequent cases that the relation-back doctrine applied not only to property in existence at the time of the original pledge-agreement, but even to property acquired by the debtor in the future, and some of the cases that followed the Sexton opinion went to the length of holding that it would apply even though both the acquisition of the property and the delivery of possession to the creditor took place within the four-month period.

It is interesting to note, parenthetically, that the application of both the "pocket lien" and "relation back" doctrines was grounded upon state law (see Benedict v. Ratner (1924), 268 U.S. 353), thus forecasting, in bankruptcy, the ultimate broad holding of Erie Railroad Co. v. Tompkins (1937), 304 U.S. 64.

II

THE 1938 AMENDMENT: ASSIGNED REASONS; PROVISIONS; AND UNANTICIPATED RESULTS

The assigned reasons for the 1938 amendment were to outlaw secret liens, and specifically to repeal, legislatively, the doctrines of these pocket-lien and relation-back cases.

Accordingly, it was provided that, for the purposes of Sections 60-a and 60-b, "a transfer shall be deemed to have been made when it becomes so far perfected that no bona fide purchaser * * * and no creditor could thereafter have acquired any rights in the property transferred superior to the rights of the transferee therein", and "if such transfer is not so perfected prior to the filing of the petition, it shall be deemed to have been made immediately before bankruptcy".

These provisions timed a transfer with reference to the hypothetical rights of a hypothetical bona fide purchaser. While, in terms, it did not confer upon the trustee the status of a bona fide purchaser, such was its effect. Its sponsors realized the dangers that lurked in language so drastic and in such a radical departure from bankruptcy principles, but urged its enactment upon the ground--not altogether unjustified--that, in view of the fashion in which the courts had handled the 1903, 1910, and 1926 amendments, it was, in the words of the principal draftsman of the 1938 amendment, "necessary to use strong language to obtain even moderate results".

Unfortunately, the sponsors did not reckon with modern judicial tendencies or the change in the personnel of the Supreme Court. While one man's guess probably--and hindsight certainly--is as good as another's, the probability is that, even if Section 60-a had been left alone or amended along moderate lines, the worst features of the pocket-lien and relation-back cases would have been curtailed, if not eliminated, anyway.

However, all that may be, the gathering thunderhead concentrated in the new language burst with the case of Klauder v. Corn Exchange National Bank & Trust Company. The court there was dealing with a bona fide written assignment of accounts, made for full consideration prior to the beginning of the four-month period. Indeed, the assignment was effected at the request of a creditors' committee and with the full knowledge of most of the assignor's creditors, in order to enable him to meet his payroll. The assignee failed to notify the account debtors, as then required under Pennsylvania decisional law, and the Supreme Court held that all of the security which the assignee thought it had was lost to it, as a preference. The sweep of the opinion was as much of a surprise to the sponsors of the amendment as to those who had forecast its possibility.

The matter was made even worse by the ruling of the District Court of Missouri in Vardaman Shoe Company (1943), 52 Fed. Supp. 562. In major aspects, the facts closely paralleled those in the Klauder case, except that the state of neither the assignor (Missouri) nor the assignee-banks (Illinois) required notification. Despite that fact, and without going into all of the refinements of the opinion, the Court held the banks' security forfeit merely because, under the law of either state as interpreted by it, a second assignee (though there was none such involved in the case) might, as against a prior assignee, have been permitted to retain payment of the accounts by the account debtors. This, indeed, was the bona fide purchaser test run riot, and placed a trustee in bankruptcy in a position of such favor that even a bona fide purchaser, qua bona fide purchaser, would not have been entitled to it.

There was some clarification of the atmosphere in Judge Goodrich's finely written opinion, which veered to the contrary, in Matter of Rosen (1946), 157 Fed. (2d) 997, but since the precise point decided in the Vardaman case was not necessarily presented for decision, it was not expressly disapproved. And such disapproval, even if declared, would still not have been binding in the circuit in which the Vardaman case was decided, to say nothing of the eight others.

The unanticipated results of the Klauder and Vardaman doctrines immediately became apparent to all banking lawyers who gave even superficial consideration to its impact. Since accounts receivable happened to be the first "guinea pig" upon which the courts had operated, and the result in the Klauder and Vardaman cases was grounded in the state law which the Federal courts deemed applicable, the situation in the accounts receivable field was ameliorated to some extent by the adoption, in a number of the more important commercial states, of so-called validation statutes, embodying the New York non-notification rule on the assignment of accounts receivable, or, where local public policy otherwise constrained, the enactment of recording (also called "notice-filing") laws. However, since even today only about half of the states have enacted statutes of either type, the matter still remained confused in those states where the rule governing such assignments had not been embodied in definite decisions, and troublesome conflict of law questions, as manifested in the Vardaman case, still remained everywhere.

But the matter did not stop there. In other important areas of lending, the secured creditor was left wide open to attack, even where he fully and promptly complied with all recording requirements. Furthermore, the very nature of these economic areas made it impossible, as a practical matter, to cure the situation by state legislation.

Illustrations will at once suggest themselves to you. Bearing in mind the interpretation of the hypothetical bona fide purchaser in the Klauder case, trust receipts were by way of becoming valueless because of the provision of Section 9 of the Uniform

Trust Receipts Act (New York Personal Property Law, Section 58-a- (2)), necessarily conferring upon the borrower the right to resell the subject-merchandise as the only commercially possible method of repaying his loan. The same consideration applied to duly filed factors' liens under Section 45 of the Personal Property Law, which, for the same basic economic reasons, confers the same right of resale upon the borrower.

Closely allied were conditional sales contracts for resale, and chattel mortgages if the chattel mortgagor was empowered to sell their subject-matter, even though, in accordance with prior accepted principles, he was required to account to the chattel mortgagee for the proceeds of the resale. Day loans on stock exchange collateral became equally vulnerable.

Then, too, there was the problem of just how great a lapse of time before recording would turn the color of the judicial litmus paper in connection with "court house" closings of real estate transactions, and, although I have no personal familiarity with the problems existing in agricultural communities, I have it on authority that the same hazards attended the making of cattle loans in the west, and cotton and other crop loans all over the nation. California, notably, complained about the effect upon airplane equipment financing, and Texas, not to be outdone in any major matter, complained about the effect upon oil leases.

The matter came to such a pass that the author of an article, brilliantly entitled "Sick Sixty", in the September 1947 issue of the Cornell Law Quarterly, were moved to begin it with the following two sentences:-

> "Think of the effect on business if the headlines of the Wall Street Journal this morning proclaimed: Supreme Court Voids All Security Devices as Bankruptcy Preferences. While such a catastrophe is not yet upon us, its probability has been foreshadowed by the wording of section 60-a of the Bankruptcy Act and the logical implications of Corn Exchange National Bank and Trust Co. v. Klauder." (Italics in original)

And, in a more moderate linguistic vein, a responsible bank official, at a Congressional hearing, testified, with disarming frankness and accuracy, that, as the result of the opinion which counsel had been compelled to give him on the subject, he was compelled for credit purposes, to treat loans purportedly secured by trust receipts and factors' liens as unsecured, and accepted such security only for what, if anything, it might be legally worth.

These fears, though regarded by some as hobgobblins, became realities with the decision of the United States District Court in Matter of Harvey Distributing Company (U.S.D.C., Eastern Dist. of Va., 1950), 88 Fed. Supp. 466. There, the security conferred by trust receipts was invalidated even though, long prior to the beginning of the four-months' period, (1) they had been delivered for full value and (2) the filing requirements of the Uniform Trust Receipts Act (which is in force in Virginia) had been complied with. The rationale of the opinion was as simple as it was disturbing: the court, while recognizing the inequity of the result reached, came to its conclusion upon the sole ground that the language of the statute, embodying the hypothetical bona fide purchaser test, left it no alternative.

A month or so before, a referee in bankruptcy in Baltimore, without formal opinion, came to the same conclusion with respect to factors' liens in Maryland. (Matter of Baltimore Casting Corporation and Matter of Liberty Motors and Engineering Corporation, not officially reported.)

Before these results came to pass, they were anticipated by the American and New York City Bar Associations and other groups, such as the American Bankers Association, the National Bankruptcy Conference, and a number of others. As early as 1945, work was commenced upon the framing and sponsorship of a remedial amendment, but we all know that legislation in so technical a field is a time-consuming process, particularly in a situation like this where the respective approaches and reactions of the many who collaborated in the effort were naturally conditioned by their varying experience, representations, and economic reactions.

But as those of us concerned in it think, the desideratum has now been accomplished with the enactment, on March 18th of this year, of P. L. 461 of the 81st Congress, amending Sections 60-a and 70-c of the Bankruptcy Act. Its clearly expressed objects and effect are

> (1) to retain unimpaired the basic objectives, but not the unintended results, of the 1938 amendment,

and to keep eliminated the pocket-lien and relation-back doctrines; (2) generally speaking, to eliminate the evils of allowing a trustee, for preference purposes, to take the position of a <u>bona fide</u> purchaser, and to restore him to the traditional position of a creditor holding a universal lien by legal or equitable proceedings in harmony with his proper functions under the Bankruptcy Act; (Here, an exception had to be made in the case of real estate transactions in order to keep outlawed the doctrine of <u>Carey v. Donohue</u>.) (3) in effectuation of the foregoing policies, to provide that no transfer, made in good faith for a new present consideration, shall constitute a preference to the extent of such consideration actually advanced if the provisions of applicable state law governing the perfection of such transfers are complied with, with an appropriate time-limitation of 21 days for such perfection if such limitation is not itself prescribed by state law; (4) equitable liens, as such, are not immunized from attack as a preference; and finally (5) as a conforming matter, Section 70-c was amended so as to place the trustee in the position of a lien creditor for all purposes, thus obliterating the former distinction between his position as [illegible] lien creditor with respect to property in the pos[illegible]n of the bankrupt, and as a judgment cre[illegible] an execution returned unsatisfied [illegible]erty.

That th[illegible]ieved enactment shortly before Korea was [illegible]k, but I hesitate to think where we would [illegible]een delayed beyond that fateful Sunday a[illegible]

W[illegible] come of diminishing importance as ti[illegible]ting question of the retroactive effe[illegible]ransactions effected prior to its en[illegible]ised. The language of the statute or [illegible] appearing in such amendments, [illegible]ise to you that, despite that fact, [illegible]preted both ways. There is much [illegible]truction of retroactivity, and the [illegible]quarely to facing the problem is

City of Chelsea (1CCA, 1928), 24 Fed. (2d) 522, which gave retroactive effect to similar, although not identical, language.

The matter is by way of being sub judice in a very practical sort of way. The Harvey case, though decided before the enactment of the present amendment, reached the Court of Appeals for the Fourth Circuit thereafter. Injecting into the problem a dosage of King Solomon, that Court remanded the Harvey case to the District Court, with instructions to reconsider it in the light of the amendment. Possibly it was constrained to do so by the consideration that the amendment is remedial and by the statements of Senator McCarran and Representative Hobbs, who were in charge of the legislation on the floors of the two Houses, that the amendment was intended only to express what Congress, in 1938, had intended in the first place.

And thus, as Lady Godiva might have said as she appraoched the end of her ride, the time has come for me to draw near my clothes. All those who collaborated in the amendment-effort believe that they have now fashioned a preference statute that is workable and fair to all concerned and that it retains all of the desirable objectives of the 1938 amendment without the unexpected and unfortunate consequences that have caused such confusion and uncertainty over the past decade. Its authors recognize that the language of this newly enacted law is not--as it could not be--simple, but they feel that it is as brief as the breadth of the necessary coverage permits, and that to anyone who reads the Congressional Committee reports and the minutes of the hearings before them, its purposes will be clear and its application free from doubt.

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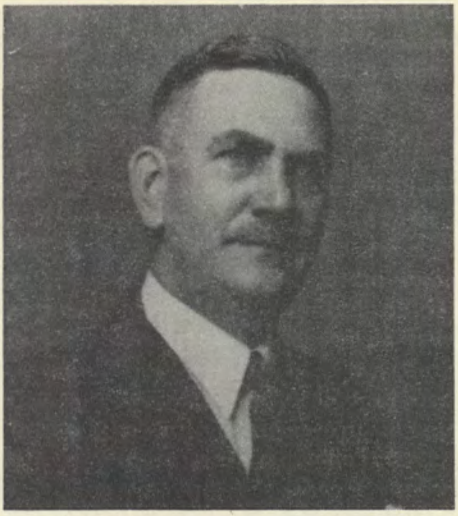

Lt. Colonel Palmer Everts

To Colonel Everts, the New York State Bar Association, and its Journal, we express our thanks for their gracious permission to reproduce this article, originally delivered at the 1950 convention of the New York State Bar Association and carried in the Bar Journal.

Unfortunately, as Colonel Everts points out, some of these meritorious items of legislation failed of passage. Nevertheless, the article is carried in "Title News" in the belief the legislative committees of our affiliated state title associations may wish to promote legislation of comparable character within their respective jurisdictions.

These proposals are for the public good rather than for the sole and selfish business interests of title companies. Their benefits redound to the public benefit and, as indicated by the title, promote liquidity in real estate transactions.

We recommend careful study of these various proposals by legislative committees of our state title associations; and by executive officers of member title and abstract companies in all the states.

Colonel Everts is Secretary, New York State Title Association. He is a member of the New York Bar. -Ed.

PROMOTING LIQUIDITY IN REAL ESTATE TRANSACTIONS

by

PALMER W. EVERTS

The constant pressure to expedite the closing of real estate transactions merits attention and study by all those engaged in handling real estate titles.

The layman who can purchase all the elements which go into a building together with its furnishings without appreciable delay, cannot readily understand the days and sometimes weeks required to perfect the purchase of real estate.

This demand for rush title service frequently comes from attorneys who would close the transaction promptly, the broker who wants his commission, the seller who wants his cash, the purchaser who wants possession and the mortgage lender would prefer to close his mortgage today rather than want until some later date to start drawing interest on his money. A saving of time in closing mortgage transactions can mean substantial sums in interest earned on the many millions loaned in this state.

With over half of American's wealth invested in real estate one can readily comprehend the broad interest of the public at large in seeking prompt and efficient title service.

It is well recognized however in the legal profession that a complete and exhaustive search of the record must be made and the chain of title thus developed must be carefully analysed and passed upon by a competent authority. Adequate protection for the investor makes it eminently essential that this work be handled with meticulous care.

The urge to expedite title work knocks on the door of all engaged in this field. It is a constant factor with attorneys who pass on the record title, the abstract companies who search the records as well as with the title insurance companies who search, examine and insure the title for the investor.

Numerous suggestions have been made which might, in some small measure, save a part of the time currently required to do this work. For example, it has been suggested that only a short search of the record need be made. This short cut is extremely unwise. It has been proven dangerous in many cases since a title record, going back only a few years, has often failed to disclose building restrictions, reversionary interests, old rights of way or other vital items recorded at an earlier date. Federal agencies universally recognize the dangers in such a short cut and demand that title be based on a search starting well back with a recognized source of basic title.

However, there is a way of promoting liquidity in real estate transfers by simplifying the work of searching through changes in and, modernization of, antiquated statutes without running the risks involved in a short streamlined search. Strangely, however, unreasonable opposition often develops to such legislation from persons who are reluctant to change existing practices.

The New York State Title Association has been active in sponsoring such legislation and giving active support to a number of bills considered helpful in this direction. For example, the Association was actively interested in a bill before the last session of the Legislature which provides a fifteen year statute of limitations on inheritance taxes. The bill (Chapter 557 of the Laws of 1950) is helpful in that it eliminates the delays incident to making any inquiries of the State Tax Department for releases in connection with old estates where there is no local record of the payment of inheritance taxes.

Unfortunately, between the time of the introduction of the bill and its passage an amendment was inserted which greatly limited its usefulness by making it applicable only to properties assessed at $10,000 or less.

A bill was sponsored which would amend the real property law so as to protect the rights of a purchaser or encumbrancer from a trustee when there is no recorded limitation on the trustee's power to make the conveyance. Various trust agreements are not recorded either because of their confidential nature or to avoid recording costs. On occasion of original acquisition an examiner may be willing to examine the trust agreement in the hands of a trustee and be afforded an opportunity to do so. On subsequent sales ten or fifteen years later the problem may be quite difficult. It was believed that the proposed change would not adversely affect the protection due to the beneficiary but would save the time involved in checking or rechecking the trust instrument--not a momentous item but still another time consuming detail. The bill passed the Assembly but died in the Senate.

Support was also given to a bill which would eliminate all dower interests. It was felt that a widow, not adequately provided for under her husband's will, now has far greater protection under her right of election than she ever had under her right of dower. If this measure became law the work of checking old records for marital status prior to 1930 could be avoided thus assisting title examiner in a limited but definite way. The bill passed both houses but was vetoed by the Governor.

Searches for a ten-year period for judgments often produce a substantial group of them which must be noted as clouds on the title. To investigate these often requires substantial time and effort on behalf of the seller and, of course, material delay. This situation is particularly difficult in a metropolitan area where there is frequent similarity of names and where a judgment creditor may have moved to another section of the city or out of the State.

A bill was introduced which would have reduced the ten-year period to three years unless the lien were filed against specific property and in which provision was made to authorize refiling at the end of each three-year period. Opposition developed however, from those who thought that the judgment creditor's rights might be impaired, and the bill was not reported out although a similar bill passed the Senate two years ago.

The legal and equitable interest of all parties must be adequately safeguarded. However, it is believed that various constructive measures can, from time to time, be developed which, through new legislation, may materially assist in expediting title work.

Such economies in time, as may be developed can in a very real and practical way be helpful to all parties in interest and, in the long run, develop resultant saving in both time and cost to the public at large for whom the service is rendered.

Constructive and remedial measures of this nature will receive active support and cooperation from all those engaged in this field of work. They merit active support by members of the bar, real estate boards, savings and loan associations, mortgage banks and others who are interested in the prompt and more expeditions handling of real estate transactions.

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ESCROWS

by

RUSSELL F. GREETER, PRESIDENT

Ohio Title Association, Assistant Vice-President Lawyers Title Insurance Corporation, Cleveland, Ohio

I have been asked to address you upon the subject of "Escrows" which is a topic of growing interest to title men everywhere. The American Title Association featured this subject in a pamphlet issued in June written by John Mann of the Law Department of the Chicago Title and Trust Company. This same subject was made the theme of a major address by Edgar Anderson at the Convention of The American Title Association in Oklahoma City in September.

The handling of escrows is one of the most dangerous and least remunerative activity in which a title company can engage. However, the use of escrow has enjoyed wide popularity in my home city. All title companies and many of our banking institutions provide such service. Elsewhere in this state you may look for a continuing development in this field due to the entrance of more and more corporate lenders whose home or branch offices are located at a considerable distance from the scene of the loan disbursement and, consequently, must utilize the services of some agent or agency in order to effect the disbursement of loan proceeds.

Escrows are used to accomplish any one or more of the following purposes:

a) To effect delivery of the purchase price subject to the conditions set forth in a written instruction. After buyer and seller have been brought together upon a binding contract of sale, many details remain to effect the ultimate consummation of the transaction. Protection is afforded both parties and the lender,the seller's deed is deposited along with the purchaser's and lender's funds if mortgage financing is required, thus eliminating such contingencies as death, withdrawal of the parties or other unforseen difficulties.

b) To effect financing arrangements and facilitate the distribution of the lender's funds concurrently with the handling of other matters incidental to the closing of the transaction, including the delivery of funds for reserves such as taxes, insurance, interest, FHA premiums, etc.

c) To give assurance to the broker that his real estate commission will be collected and remitted.

d) To permit funds to be held until such time as certain specified liens, defects or incumbrances are removed.

e) To hold funds until improvements have been installed which may be required by Federal Housing Administration,thus permitting the insurance of notes prior to the actual completion of the improvements such as paving, gutters, curbing, sewers, etc.

f) To permit the closing of a transaction involving premises located at some distant point without requiring the parties to journey to the location of the property.

It would,of course,be impossible to detail all the advantages accruing from the use of an escrow. It is a flexible device which can be readily adapted to the many changing conditions which are encountered in the daily transfer of real property,no small number of which are brought about by governmental regulations. The chief aim of all title companies should be to make the handling of real estate transactions as expeditious as possible commensurante with the rules of safety. By detaining funds in escrow very often a transaction can be closed and liens, incumbrances or defects removed at the later convenience of the parties.

Our Supreme Court in the case of Squire vs. Branciforte 131 O.S. 344 has defined an escrow as follows: "An escrow as between grantor and grantee of realty in Ohio is witnessed by a written instrument known as an escrow agreement by the mutual consent of both parties to a third party denominated the depositary or escrow agent wherein certain conditions are imposed by both grantor and grantee which depositary or escrow agent by acceptance and retention of the escrow agreement agrees to observe and obey the same."

It should be noted that where future delivery is predicated upon the payment of money, or the performance of some other condition, an escrow will be considered to have been established. Where delivery of a deed is merely to await the lapse of time or the happening of some contingency and not the performance of a condition, it will be deemed the grantor's deed presently. To create an escrow delivery to a third person or agency is essential, otherwise, it is the present deed of the grantor if delivered to the grantee named in the deed. It has been held, however, that a party may deposit a deed with his attorney in escrow.

Deeds, or other written instruments, may properly be deposited as an escrow. Other written instruments such as subscriptions to canal funds, instruments of release of alimony, written releases from obligations under promissory notes and instruments of similar import and, of course, money may be delivered into escrow. Both parties may deliver documents and instruments into escrow but it is the grantor who prescribes the terms upon which a deed may be delivered and become operative as such. It should be specially noted here that the escrow agent is without authority to prorate taxes, insurance, rentals and other items in the absence of specific written authority to that effect. If such instructions are lacking, his duty is limited to the delivery of the deed upon the performance of the requisite conditions.

It is to be observed that a deed deposited as an escrow pursuant to a valid contract that it shall be delivered upon the fulfillment of a condition in the contract may not during the time allowed for performance of the condition be revoked by the party depositing the instrument. The title to the instrument pending performance of the condition or until its breach has passed from the grantor and delivery thereof to the grantee by the depositary is good even though it is made in the face of the protests and against the will of the grantor. By the act of depositing an instrument in escrow the grantor relinquishes all dominion over the same, subject to the terms of the contract imposing terms relative to its ultimate delivery.

The depositary is an agent of both parties for the purpose of making delivery of the several documents and funds placed upon deposit. The depositary has sometimes been defined as the trustee of an express trust with duties to perform for each of the parties, the performance of which neither can forbid without the consent of the other. Ohio appears to incline to the theory that the depositary is a trustee due to the pronouncements of the Supreme Court in a number of cases which arose following the banking holiday. In a leading case where it was shown that the bank acting as escrow agent had received certain funds in accordance with the terms of an escrow, it was held that the bank was a trustee of such funds and was directed to return the same to the depositor in preference to all other depositors in the institution even though such funds had been comingled with other money in the bank.

Some writers take the view that the depositary is a special agent limited to the authority given in the document creating the escrow. In any event, trustee or agent, the depositary must adhere strictly to the terms of the written instructions and departure from the same in any essential matter shall fix its liability. The depositary, of course, must have no interest in the subject matter of the transaction, otherwise, it acts at its peril.

The escrow agent, however, is not an insurer of the acts of the parties; he is not the legal counsel of the parties, nor is it incumbent upon him to exercise legal acumen to point out the rights of each; nor is he required to counsel as to the prudence of the transaction or act as advisor as to real estate values. The sole duty devolving upon the escrow agent is to carry forward the terms of the writing as delivered. A recent California case has held that in a situation where the escrow agent was also the title insurer no duty devolved upon it to make a disclosure of information to the parties which came into its possession as title insurer.

Since the title to property to be conveyed in an escrow as a general rule remains in the grantor pending performance by the grantee the right to recover for loss of the property by fire during the pendency of the escrow remains in the grantor. A prudent escrow agent will, of course, at all times see to it that the property is adaquately covered for fire and windstorm while the escrow is in progress.

By the great weight of the American doctrine the death of either party occuring after the deposit but before the condition is performed or final delivery is had, does not affect the contract of escrow; rather the final delivery is by fiction of law said to obtain upon performance of the condition as of the time of original deposit. This has been pronounced by the Supreme Court of Ohio as the prevailing doctrine in this State. Hood vs. Brown 2 Ohio 266 and Farley vs. Palmer 20 O.S. 233 and Rothmell vs. Shirley 60 O.S. 187 all support this view. In this last case the Court held that an instrument for the conveyance of lands without valuable consideration, deposited with a third person as an escrow to be by him delivered to the grantee on the death of the grantor does not by relation, vest the title in the grantee at the date of the first delivery to the prejudice of persons who thereafter without knowledge of the existance of the instrument extend credit to the grantor. The court, however, is emphatic that in the absence of the creditors the title would unquestionably have passed to the named grantee upon the death of the grantor.

In only one Ohio case is the question raised as to the title passing upon the death of a party. In the case of Schurtz, Admr. vs. Calvin, et al, 55 O.S. 274 Judge Minshall by way of dicta remarked "And so a deed held in escrow delivered after the death of the principal passes no title." That case involved a situation where a man living in Missouri left a deed with his attorney in Ohio, he to retain the same until a vendor's lien was liquidated, or a mortgage given to secure the purchase price. Upon the representation to the attorney that the deed was desired merely to copy the description, he obligingly delivered it to the grantee. The grantee thereupon took the deed to a prospective lender representing that he was the owner, exhibiting the deed as proof. Thereafter he proceeded to file the deed along with the mortgagee which he procured. The Court upon the issue raised, held that the mortgage being innocent of the facts held a valid mortgage as against the original grantor. The case has nothing to do with the death of anyone. Therefore, it may safely be said that Ohio is in line with the great weight of national authority.

I would like to add a word of caution about detaining funds in escrow pending the removal of liens or for other reasons. The escrow agent should use the utmost caution in surrounding such procedure with every safeguard for himself as the detaining of funds can become a great headache. Generally speaking funds should not be held for the removal of any objection which cannot certainly be discharged through the payment of money.

We have frequent requests that funds be impounded pending the discharge of a mechanic's or materialmen's lien. Extreme care should, of course, be used to ascertain that sufficient funds be withheld to secure all principal amounts plus interest, plus all court costs including those accruing in any reviewing court. It must also be remembered that during the period while the validity of the lien is being contested in the courts, if such procedure becomes necessary, the title is rendered unmarketable. Therefore, the assent of the mortgagee and the purchaser's consent to the arrangement and as to the amount to be held should be obtained. Frequently mortgages are assigned in which event the assignee, having no knowledge of the original arrangement, would expect you to deliver upon the basis of the title policy as issued showing no defects. Since so many pitfalls are involved, we have refused uniformly to detain funds under the circumstances as outlined.

In every case where you assume an obligation to pay funds from the proceeds of an escrow, be certain to secure the assent of the party directing payment as to the stipulated amount to be paid; provide against the contingency that the funds may never come into your hands, or that they may not remain in your possession at the time payment is demanded, or that you may be prevented from making payment due to the intervention of public authority as exercised through bankruptcy, receivership, injunction, or assignment for the benefit of creditors.

If funds are held to pay an unsecured material bill, be certain that you do not lay yourself open to the possibility of having a claim filed against you due to the fact that you allow the time for filing a materialmen's lien to pass and then find that you are unable to make payment. In the bankruptcy which may follow, the claimant will discover himself to be an unsecured creditor.

Escrow instructions which you receive, even when prepared by counsel, often leave much to be desired and the way of the escrow agent is not always strewn with roses. From the very nature of the business it must often be transacted quickly and under great pressure. Do not feel badly if you do not please all parties to an escrow and be tolerant with your competitor if the complaints of a disgruntled party are relayed to you. Seldom does a man with a complaint relate the facts but he is more likely to distort them to favor his own particular view of a transaction.

It is well to keep in mind that you may have taken on liability with respect to the condition of a title over and above what you would ordinarily assume as a title insurer by the acceptance of certain escrow instructions. In order to limit the liability of the escrow agent "Conditions of Acceptance" have been devised and are customarily attached to every escrow instruction. These conditions limit the liability of the depositary and clearly define the circumstances under which liability is assumed. Copies of these "Conditions" are available here, or I shall mail a copy to anyone making a request.

It is well for every escrow agent to keep in mind that he is engaged in a very serious business--disbursing money which is owned by other people.

Frequently the funds on deposit represent the life savings of an individual or the proceeds of a loan made by a life insurance company. Periodical checks should be made to review procedures in order that risk may be held to a minimum. Personnel should be carefully chosen for competency and honesty, and should be covered by adequate bond. Insurance against theft of funds and valuables in the office and while in transit should be carried in sufficient amount. Insurance covering the possibility of losing documents should be carried. Insurance against the possibility of an endorsement being forged upon the check issued by the depositary is highly desirable. An escrow agent, like Caesar's wife, should be beyond reproach, as he is deemed by the law to be a fiduciary. Do not be satisfied with merely being legally right; impose every possible safeguard. It is one thing to be on sound legal ground and another thing to prove it at the end of costly litigation. Furthermore, one of the parties involved may be a valued customer with whom an argument may prove costly for a long time to come.

For a long time we have been much concerned about the custody of funds left on deposit with us. Accordingly, we took this matter up with the Comptroller of the Treasury and obtained a ruling to the effect that if the funds of "X" party were delivered to us in escrow and we maintained the ledger account in such fashion that we could trace all deposits and withdrawals from that account by checks drawn on the same bank, then such account of "X" party would be insured to the extent of $10,000.00 in the event the bank failed. All provided, of course, that "X" party carried no other account at the same bank. There should never be any comingling of funds in the escrow account, and it should never be used as a depositary except for trust funds. As fees accrue to the depositary they should be withdrawn within a reasonable period so that at all times the ownership of the account can be conclusively demonstrated.