

1-1-1985

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Karen Lee Jacobsen

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Recommended Citation

Karen L. Jacobsen, *California Escrow Agents: A Duty to Disclose Known Fraud?*, 17 PAC. L. J. 309 (1985).

Available at: <https://scholarlycommons.pacific.edu/mlr/vol17/iss1/16>

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California Escrow Agents: A Duty to Disclose Known Fraud?

In California, most transactions affecting title to real property are consummated through an escrow.¹ Escrows have been used as early as the Blackstonian Era.² The original doctrine, only referred to the document delivered to a third person and held until the performance of the specified conditions.³ Modernly, however, the statutory definition covers the entire transaction from the time the escrow agent receives the instructions to the delivery of the conveyance, release of the purchase money to the seller, and payment of commissions to the broker.⁴

The use of escrows has become indispensable in modern commercial transactions.⁵ Escrows are employed in real estate transactions as well as transactions involving loans, personal property, and sales of promissory notes secured by trust deeds.⁶ The purpose of creating

1. A. Bowman, *Real Estate Law in California* 368 (1958). CALIFORNIA FINANCIAL CODE §17003 provides:

“Escrow means any transaction where in one person, for the purpose of effecting the sale, transfer, encumbering, or leasing of real or personal property to another person, delivers any written instrument, money, evidence of title to real or personal property, or other thing of value to a third person to be held by such third person until the happening of a specified event or the performance of a prescribed condition, when it is then to be delivered by such third person to a grantee, grantor, promisee, promisor, obligee, obligor, bailee, bailor, or any agent or employee of any of the latter.”

Id.

2. See W. Blackstone, *Blackstone's Commentaries on the Law* *307 (B. Cavit 2d ed. 1941).

3. *Id.*

A delivery may be absolute, . . . or to a third person, to hold till some conditions be performed on the part of the grantee: in which last case it is not delivered as a deed, but as an escrow, that is, as a scroll or writing, which is not to take effect as a deed till the conditions be performed; and then it is a deed to all intents and purposes.

Id.

4. CALIFORNIA FINANCIAL CODE §17003 (enacted in 1951 as part of the Escrow Law; expanding the statutory definition of “escrow” to include the entire transaction).

5. Anderson, *Escrows as Method of Bringing in and Keeping Customers*, 30 *Title News* 2 (1951).

6. See CALIFORNIA FINANCIAL CODE §17003. Escrows may be used in transactions affecting real or personal property and may involve conditional delivery of any written instrument, money, and evidence of title to real or personal property or other thing of value. *Id.*; see, e.g., *Bailey v. Security Trust Co.*, 179 Cal. 540, 548, 177 P. 444, 447 (1919) (stock certificates); *Witmer Bros. Co. v. Weid*, 108 Cal. 569, 574, 41 P. 491, 493 (1895) (promissory notes); *Foster v. Los Angeles Trust & Sav. Bank*, 36 Cal. App. 460, 462, 172 P. 392, 393 (1918) (money). The discussion in this comment will be limited to the use of escrows in real property transactions although the concepts discussed extend to other transactions.

an escrow is to have a neutral third person handle the conflicting interests of the parties to a transaction.⁷

Aware of the growing escrow industry, the state legislature enacted the California Escrow Law in 1951.⁸ The purpose of the Escrow Law is to protect the public from unfair, fraudulent, and incompetent service by escrow agents.⁹ The Escrow Law accomplishes this goal by subjecting the escrow industry to licensing requirements and regulation by the Commissioner of Corporations.¹⁰ The legislature has enacted procedural regulations for the protection of the public,¹¹ but has failed to define specifically the legal relationship of an escrow agent to the parties to the escrow arrangement.¹²

Courts have defined the escrow agent's relationship to the parties as a *limited* agency.¹³ In an escrow agreement, the vendor and purchaser are principals and the escrowee is an agent for both parties.¹⁴ The obligations of the escrow agent, however, are determined solely by the terms of the escrow agreement.¹⁵

In contrast, a *general* agency creates a fiduciary relationship between a principal and an agent.¹⁶ As a fiduciary, the agent assumes a duty to act primarily for the benefit of the principal in matters connected with the undertaking.¹⁷ The duty includes: (1) disclosing material information to the principal;¹⁸ (2) not competing with the

7. Blackburn v. McCoy, 1 Cal. App. 2d 648, 654-55, 37 P.2d 153, 155 (1935).

8. CALIFORNIA FINANCIAL CODE §§17000-17654. The original version of the Escrow Law was enacted in 1947. The provisions of the act were supplemented and re-enacted in 1951, making CALIFORNIA FINANCIAL CODE §§17000-17654 which is commonly known as the California Escrow Law. Comment, *The Independent Escrow Agent: The Law and the Licensee*, 38 So. CAL. L. REV. 289, 291 (1965).

9. Escrow Institute of California v. Pierno, 24 Cal. App. 3d 361, 366, 100 Cal. Rptr. 880, 883 (1972).

10. *Id.* CALIFORNIA FINANCIAL CODE §17006 states that:

Escrow law does not apply to banks, trust companies, building and loan or savings and loan associations, insurance companies, attorneys not actively engaged in conducting an escrow agency, title insurance companies or real estate brokers while performing acts in the course of or incidental to real estate business because they already are subject to stringent statutes and regulatory provisions governing the conduct of their business or profession.

Id.

11. CALIFORNIA FINANCIAL CODE §§17000-17654.

12. See *infra* notes 60-172 and accompanying text.

13. See *infra* notes 79-172 and accompanying text.

14. See, e.g., Shreeves v. Pearson, 194 Cal. 699, 707, 230 P. 448, 451 (1924).

15. See *infra* notes 79-172 and accompanying text.

16. RESTATEMENT (SECOND) OF AGENCY §13, comment a (1957).

17. *Id.*

18. See, e.g., Menzel v. Salka, 179 Cal. App. 2d 612, 622, 4 Cal. Rptr. 78, 84 (1960); see W. Prosser, Handbook of the Law of Torts §106, at 696-97 (4th ed. 1971).

principal in matters relating to the subject of the agency;¹⁹ and (3) exercising good faith on behalf of the principal.²⁰

Since the escrow arrangement creates a limited agency, the fiduciary duty of the escrow agent to disclose material information is limited to the terms of the escrow instructions.²¹ Escrow instructions are prepared on the escrow agent's printed forms.²² Unless requested by the parties to the escrow, the instructions generally do not impose upon the escrow agent a duty to disclose.²³ Escrow agents, therefore, may know that a fraud is being committed by one party to the transaction and remain silent without incurring liability.²⁴ The result is that the parties to the transaction are unprotected.²⁵

In applying breach of fiduciary duty concepts to the limited agency, courts have confused legal principles and rules.²⁶ Much of the confusion stems from whether a cause of action exists for breach of a fiduciary duty to disclose.²⁷ Civil Code section 2020 seems to impose a broad duty to disclose upon an escrow agent.²⁸ California courts, however, have narrowly construed the escrow agent's duty to disclose.²⁹ Furthermore, California courts have dismissed attempts to create a duty to disclose known frauds.³⁰

The purpose of this comment is to examine and clarify the duty owed by an escrow agent in California to both principals of the agreement. Initially, the history of the struggle to categorize the escrow agency into various bodies of law with established legal concepts will be reviewed.³¹ The potential causes of action available to a principal against an escrow agent will be explored, including breach of contract,³² negligence,³³ and breach of fiduciary duty.³⁴ In addition,

19. *Menzel*, 179 Cal. App. 3d at 84; RESTATEMENT (SECOND) OF AGENCY §13, comment a (1957).

20. *Menzel*; 179 Cal. App. 2d at 622, 4 Cal. Rptr. at 84; RESTATEMENT (SECOND) OF AGENCY §13, comment a (1957).

21. See *infra* notes 79-172 and accompanying text.

22. A. Bowman, *Real Estate Law in California* 138 (1982).

23. See *infra* notes 79-172 and accompanying text.

24. *Id.*

25. See *Lee v. Title Ins. & Trust Co.*, 264 Cal. App. 2d 160, 163-64, 70 Cal. Rptr. 378, 380 (1968); *Blackburn*, 1 Cal. App. 2d at 654, 37 P.2d at 155.

26. See *infra* notes 79-172 and accompanying text.

27. *Id.*

28. CAL. CIV. CODE §2020.

29. See *Spaziani v. Millar*, 215 Cal. App. 2d 667, 684, 30 Cal. Rptr. 658, 667 (1963).

30. See *infra* notes 79-106 and accompanying text.

31. See *infra* notes 40-61 and accompanying text.

32. See *infra* notes 66-78 and accompanying text.

33. *Id.*

34. See *infra* notes 79-172 and accompanying text.

the different factual situations to which each theory applies will be illustrated.

An in-depth analysis of the breach of fiduciary duty cases will reveal the policy behind prior holdings that an escrow agent does not have a fiduciary duty to disclose.³⁵ This author will demonstrate that these policies do not apply if the escrow agent has knowledge that one party to the escrow is defrauding the other.³⁶ One state has expanded the limited agency theory to include a duty to disclose when the escrow agent knows that a fraud is being committed by a party to the escrow.³⁷ This author proposes that California courts similarly should require an escrow agent to disclose known frauds.³⁸ First, however, a brief historical discussion is necessary to understand the difficulty courts have had in defining the legal status of the escrow agent.

HISTORICAL BACKGROUND OF THE ESCROW RELATIONSHIP

Although dicta often state that the escrow agent occupies a "definite niche in the body of law," the status of an escrow agent is one of the most anomalous in our system of jurisprudence.³⁹ Descriptions of the legal status of an escrow agent have been in terms of many well-defined legal principles, never attaining an independent character.⁴⁰ Courts have classified the escrowee as an agent of both parties,⁴¹ a limited or special agent,⁴² a trustee of an express trust,⁴³ both an agent and a trustee,⁴⁴ and a custodian or stakeholder.⁴⁵

Commentators have suggested that the legal position of an escrow agent should be *sui generis* because of the possible incompatibility of applying one body of law to another.⁴⁶ This possible incompatibility can be illustrated by two applications of agency law to the escrow agent.⁴⁷ First, the death of the principal revokes an agency.⁴⁸ The

35. *Id.*

36. See *infra* notes 173-95 and accompanying text.

37. See *id.*

38. See *infra* notes 197-220 and accompanying text.

39. *Squire v. Branciforti*, 2 N.E.2d 878, 882 (Ohio 1936), see Comment, *Escrows—Defalcation of Escrow Holder*, 31 OR. L. REV. 218, 219 (1952).

40. See Comment, *supra* note 39, at 219.

41. *Shreeves*, 194 Cal. at 707, 230 P. at 451.

42. *Blackburn*, 1 Cal. App. 2d at 654, 37 P.2d at 155.

43. *Foulkes v. Sengstacken*, 163 P. 311, 314 (Or. 1917).

44. *Feisthamel v. Campbell*, 55 Cal. App. 774, 781, 205 P. 25, 28 (1921).

45. *Citizens Nat'l Bank of Roswell v. Davisson*, 229 U.S. 213, 223 (1913).

46. For further discussion of this argument, see Comment, *supra* note 39, at 219; Comment, *A Survey of Escrow—A Legal Adolescent*, 8 ARK. L. REV. 164, 171 (1953-54).

47. See *infra* notes 48-52 and accompanying text.

48. See *Los Angeles Trust & Sav. Bank v. Ward*, 197 Cal. 103, 108-09, 239 P. 847, 849

death of a vendor or vendee to an escrow arrangement, however, does not terminate the power or duties of the escrow agent.⁴⁹ Moreover, although a principal may revoke an agency, except in the case of an agency coupled with an interest, the vendor or vendee cannot terminate the escrow.⁵⁰

Second, conditional delivery of a deed to the grantee is considered an absolute delivery upon which title immediately passes.⁵¹ Under a traditional agency theory, therefore, if the escrow agent is the agent of the grantee, conditional delivery of a deed would be considered absolute and title would pass immediately.⁵² The result would be destruction of the traditional function of the escrow agent.

Similarly, the difficulty of applying trust law to the escrow agent can be illustrated in two examples.⁵³ First, delivery of an instrument in escrow conveys no legal title,⁵⁴ whereas delivery in trust shifts legal title to the trustee.⁵⁵ Second, a valid trust can be created with an express power of revocation,⁵⁶ whereas a valid escrow cannot be created if a power of revocation is retained.⁵⁷

The above examples reveal the difficulty of classifying an escrow relationship under general agency or trust principles.⁵⁸ Courts, therefore, generally categorized the escrow relationship as a limited agency.⁵⁹ An analysis of the potential causes of action available against an escrow agent will be examined to demonstrate the confusion regarding breach of the fiduciary duty to disclose material information.

THEORIES OF LIABILITY

Breach of contract, negligence, and breach of fiduciary duty are

(1925) (the court stated if the escrow agent was only an agent of the grantor, his agency would cease on the grantor's death).

49. *Law v. Title Guar. & Trust Co.*, 91 Cal. App. 621, 630, 267 P. 565, 569 (1968).

50. See H. Miller & M. Starr, *Current Law of California Real Estate* §12:91 (1977); see also 3 B. WITKIN, *SUMMARY OF CALIFORNIA LAW, REAL PROPERTY* §135, at 1880 (8th ed. 1974).

51. See Comment, *supra* note 40, at 220.

52. *Id.* at 220-21.

53. See *infra* notes 54-57 and accompanying text.

54. CAL. CIV. CODE §1057; see, e.g., *People v. Hess*, 104 Cal. App. 2d 642, 681-82, 234 P.2d 65, 90 (1951) (the court stated that deposit of moneys in an escrow does not alter or change ownership).

55. *Los Angeles Trust & Sav. Bank*, 197 Cal. at 110-11, 239 P. at 850 (the court conceded there may be some similarities between an escrow agent and a trustee, but distinguished the trust situation as where title to the trust property is vested in the trustee).

56. See Comment, *supra* note 39, at 224.

57. *Id.*

58. See *supra* notes 47-57 and accompanying text.

59. See *infra* notes 79-172 and accompanying text.

potential causes of action against an escrow agent.⁶⁰ California courts consistently have recognized the breach of contract and negligence theories.⁶¹ The courts have recognized that the escrow agent is a fiduciary and owes a fiduciary duty to the parties to the escrow.⁶² The scope of the fiduciary duty, however, has been the subject of inconsistent analysis.⁶³

The breach of fiduciary duty to disclose theory will be examined to illustrate the confusion courts have encountered in differentiating between various legal theories.⁶⁴ California Civil Code section 2020 will be discussed to determine the applicability to the escrow agent and the effect upon the scope of the fiduciary duty.⁶⁵ First, however, an analysis of the breach of contract and negligence theories will illustrate the different factual situations to which each theory applies.

A. Breach of Contract and Negligence

Although frequently alleged together, breach of contract and negligence are two separate and distinct causes of action.⁶⁶ In *Amen v. Merced County Title Co.*,⁶⁷ the escrow agent received notice from the state that the purchaser of a tavern was required to obtain a sales tax clearance certificate.⁶⁸ The escrow instructions provided that any debts should be paid out of the proceeds of the sale.⁶⁹ The escrow agent failed to notify the buyer, which resulted in attachment of a tax lien to the property.⁷⁰ The plaintiff brought suit against the escrow agent alleging breach of contract and negligence.⁷¹ The court held the defendant liable for the amount of the tax lien under both theories.⁷²

60. See *infra* notes 61-172 and accompanying text.

61. See, e.g., *Amen v. Merced County Title Co.*, 58 Cal. 2d 528, 532, 375 P.2d 33, 34, 25 Cal. Rptr. 65, 67 (1962) (the court held defendant liable on breach of contract and negligence theories); *Ruth v. Lytton Sav. & Loan Ass'n*, 266 Cal. App. 2d 831, 842-43, 72 Cal. Rptr. 521, 529 (1968) (the court held that the defendant was negligent and had breached the escrow instructions).

62. *Spaziani*, 215 Cal. App. 2d at 681-82, 30 Cal. Rptr. at 666.

63. See *infra* notes 79-172 and accompanying text.

64. *Id.*

65. See *infra* notes 109-32 and accompanying text.

66. See *Amen*, 58 Cal. 2d at 531-32, 375 P.2d at 35, 25 Cal. Rptr. at 67; *Ruth*, 266 Cal. App. 2d at 833, 72 Cal. Rptr. at 522.

67. 58 Cal. 2d 528, 375 P.2d 33, 25 Cal. Rptr. 65 (1962).

68. *Id.* at 531, 375 P.2d at 34, 25 Cal. Rptr. at 66.

69. *Id.*

70. *Id.*

71. *Id.* at 530, 375 P.2d at 34, 25 Cal. Rptr. at 66.

72. *Id.* at 532, 375 P.2d at 35, 25 Cal. Rptr. at 67.

Under the breach of contract theory, an escrow agent has a duty to comply strictly with the terms of the escrow instructions.⁷³ The escrow agent had breached an express provision of the escrow instructions by failing to pay the tax lien out of the proceeds of the sale.⁷⁴ Additionally, the court held that the escrow agent had breached an implied promise by failing to inform the plaintiff of the potential tax liability.⁷⁵

Under the negligence theory, an escrow agent has a duty to exercise ordinary skill and diligence in his employment.⁷⁶ The escrow agent was negligent in failing to inform the plaintiff of the potential tax liability.⁷⁷ California courts have given consistent treatment to the recognized causes of action of breach of contract and negligence.⁷⁸ The courts have been less consistent, however, when deciding breach of fiduciary duty claims.

B. Breach of Fiduciary Duty

*Blackburn v. McCoy*⁷⁹ was the first California case to determine the fiduciary duties owed by the escrow agent to the seller and buyer of real estate.⁸⁰ The plaintiff buyer allegedly was induced to invest her money through fraudulent misrepresentations that were known to the escrow agent.⁸¹ The plaintiff further alleged that the escrowee, her agent, had a duty to disclose information material to her decision to enter into the transaction.⁸² The evidence supported a finding of fraud and deceit,⁸³ but the court held that the escrow agent was under no obligation to disclose the information.⁸⁴

Noting the diversity of opinion regarding the escrowee's status as an agent or trustee for the parties to the escrow, the court held that the escrowee was an agent.⁸⁵ The court concluded, however, that a

73. *Id.* at 531, 375 P.2d at 35, 25 Cal. Rptr. at 67; *see, e.g.*, Ruth, 266 Cal. App. 2d at 839, 72 Cal. Rptr. at 527.

74. *Amen*, 58 Cal. 2d at 531, 375 P.2d at 35, 25 Cal. Rptr. at 67.

75. *Id.* at 531, 375 P.2d at 35, 25 Cal. Rptr. at 67.

76. *Id.*; *see, e.g.*, Rianda v. San Benito Title Guar. Co., 35 Cal. 2d 170, 173, 217 P.2d 25, 27 (1950).

77. *Amen*, 58 Cal. 2d at 532, 375 P.2d at 35, 25 Cal. Rptr. at 67.

78. *E.g.*, Rianda, 35 Cal. 2d at 173, 217 P.2d at 27; Common Wealth Ins. Systems, Inc. v. Kersten, 40 Cal. App. 3d 1014, 1031, 115 Cal. Rptr. 653, 664 (1974).

79. 1 Cal. App. 2d 648, 37 P.2d 153 (1934).

80. *Id.* at 654-55, 37 P.2d at 155-56.

81. *Id.* at 650, 37 P.2d at 153.

82. *Id.* at 654, 37 P.2d at 155.

83. *Id.* at 657, 37 P.2d at 157.

84. *Id.* at 655, 37 P.2d at 156.

85. *Id.* at 654, 37 P.2d at 155; *see Comment, supra* note 39, at 219.

general agency did not exist between the parties and the escrow agent.⁸⁶ An escrow agent owes duties to two parties with conflicting interests.⁸⁷ The court reasoned that the duty to disclose fraud to one principal conflicts with the duty of loyalty to the other principal.⁸⁸ The relationship, therefore, must be classified as a *limited* agency.⁸⁹ Furthermore, the court concluded the scope of the limited agency was determined by the express terms of the escrow instructions.⁹⁰

The *Blackburn* court stated that the purpose of creating an escrow is to provide a neutral third person to handle conflicting interests of the parties to a transaction.⁹¹ The fundamental principles of loyalty underlying a general agency, therefore, do not apply in an escrow situation.⁹² The court also noted that an important factor in the development of the escrow method of handling conveyances is that the obligations of the escrow agent are limited to the escrow instructions.⁹³ Since the escrow instructions did not require the escrow agent to inform the plaintiff of the fraudulent practices of the defendant, no violation of the duty to disclose was found.⁹⁴

Another opportunity for the court to determine the scope of the escrow agent's fiduciary duty arose in 1968, in *Lee v. Title Ins. & Trust Co.*⁹⁵ The gravamen of the action was the defendant's failure to disclose a known fraud.⁹⁶ The plaintiffs alleged that the escrow agent knew about the fraud but failed to notify them.⁹⁷ The court reaffirmed *Blackburn* and held that an escrow agent is not liable for failing to do an act not required by the terms of the escrow.⁹⁸

The issue presented in *Lee* was whether an escrow agent is under a fiduciary duty to go beyond the escrow instructions and notify each party of suspicious facts or circumstances that arise before or during the life of the escrow that conceivably could affect a decision to complete the transaction.⁹⁹ The *Lee* court stated that imposing a duty

86. *Blackburn*, 1 Cal. App. 2d at 654-55, 37 P.2d at 155-56.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. *See id.* at 654-55, 37 P.2d at 155.

93. *Id.* at 655, 37 P.2d at 155-56; *Lee*, 264 Cal. App. 2d at 164, 70 Cal. Rptr. at 380-81.

94. *Blackburn*, 1 Cal. App. 2d at 655, 37 P.2d at 156.

95. 264 Cal. App. 2d 160, 70 Cal. Rptr. 378.

96. *Id.* at 161, 70 Cal. Rptr. at 378-79.

97. *Id.*

98. *Id.* at 163-64, 70 Cal. Rptr. at 380. *Contra* *Berry v. McLeod*, 604 P.2d 610, 616 (Ariz. 1979).

99. *Lee*, 264 Cal. App. 2d at 162, 70 Cal. Rptr. at 379.

to disclose on an escrow agent would create a dilemma.¹⁰⁰ Once information was received, the escrow agent would be forced to decide whether to believe and disclose or disbelieve and conceal the knowledge.¹⁰¹ If the knowledge is concealed, the escrow agent risks suit for breach of fiduciary duty to disclose a known fraud.¹⁰² If the information is disclosed, but is inaccurate, all parties to the escrow may sue the escrow agent for interference with the contract.¹⁰³ Furthermore, the court in *Lee* stated that subjecting escrow agents to a high risk of litigation would damage a valuable business procedure.¹⁰⁴ A judicially imposed duty to disclose would discourage a reasonably prudent person from acting as an escrow agent.¹⁰⁵ Ultimately, the very purpose for which escrows originated would be defeated because the escrow agent would lose his neutrality.¹⁰⁶

In *Blackburn* and *Lee*, the courts held that no duty to disclose known fraud exists unless required by the terms of the escrow instructions.¹⁰⁷ Crucial to the analysis in those cases was the fact that the escrow instruction lacked an express provision creating an affirmative duty to disclose.¹⁰⁸ In contrast, California Civil Code section 2020 imposes a duty upon the escrow agent to exercise ordinary care to communicate information to a principal.¹⁰⁹ The escrow agent must reveal knowledge of material facts acquired in the course of his agency that might affect the decision of the principal in a pending transaction.¹¹⁰

The language seems to require a broad duty to disclose.¹¹¹ The courts, however, have construed section 2020, a general agency provision, consistently with the notion of a limited agency.¹¹² The fiduciary duty to communicate with the principal under section 2020, therefore, is limited to knowledge acquired under the terms of the escrow agreement.¹¹³ *Spaziani v. Millar*¹¹⁴ is illustrative of the application of section 2020.

100. *See id.* at 163, 70 Cal. Rptr. at 380.

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.*

106. *See id.*; *see Blackburn*, 1 Cal. App. 2d at 654-55, 37 P.2d at 155-56.

107. *See supra* notes 79-106 and accompanying text.

108. *Id.*

109. CAL. CIV. CODE §2020. An agent must use ordinary diligence to keep his principal informed of his acts in the course of his agency. *Id.*

110. *Id.*; *Spaziani*, 215 Cal. App. at 684, 30 Cal. Rptr. at 667.

111. *See CAL. CIV. CODE* §2020.

112. *Spaziani*, 215 Cal. App. at 684, 30 Cal. Rptr. at 667.

113. *Id.*

114. 215 Cal. App. 2d 667, 30 Cal. Rptr. 658 (1963).

In *Spaziani*, the plaintiff had given the escrow agent indefinite and ambiguous instructions.¹¹⁵ The escrow agent knew that the first deed of trust was to secure a construction loan and subsequently learned that the loan was a purchase assistance loan.¹¹⁶ Furthermore, the agent knew the terms of repayment were different than those agreed upon in the deposit receipt.¹¹⁷ The escrow agent allowed the escrow to close without communicating the information to the plaintiff.¹¹⁸ The court held the defendant was negligent and had breached the fiduciary duty owed to the plaintiff.¹¹⁹

In reaching this decision, the court relied upon Civil Code section 2020.¹²⁰ The court stated that section 2020 imposes a duty upon agents to exercise ordinary care in communicating knowledge acquired in the course of an agency to the principal.¹²¹ Since the type of loan required was within the terms of the escrow instructions, the escrow agent had a duty to disclose the information to the plaintiff.¹²²

The *Spaziani* court summarized the existing legal theory regarding escrow agents in California.¹²³ California law provides that an escrowee is the agent of all parties prior to performance of the conditions of the escrow.¹²⁴ An escrow agent bears a fiduciary relationship to each party.¹²⁵ The court also stated the obligations of the escrow agent to each party are measured by application of ordinary agency principles.¹²⁶ The reference to ordinary agency principles suggests an escrow is similar to a general agency.¹²⁷ The court qualified the reference, however, by stating that the escrow agent's duty to disclose must be viewed in light of the nature of the existing fiduciary relationship.¹²⁸

The nature of the fiduciary relationship between the escrow agent

115. *Id.* at 681, 30 Cal. Rptr. at 666.

116. *Id.* at 681-82, 30 Cal. Rptr. at 666.

117. *Id.* at 683, 30 Cal. Rptr. at 667.

118. *Id.*

119. *Id.* at 684, 30 Cal. Rptr. at 667.

120. *Id.*

121. *Id.*; see *Contini*, 40 Cal. App. 3d at 547, 115 Cal. Rptr. at 263-64.

122. See *Spaziani*, 215 Cal. App. 2d at 683, 30 Cal. Rptr. at 667.

123. *Id.* at 682-84, 30 Cal. Rptr. at 666-67; see, e.g., *Amen*, 58 Cal. 2d at 531-32, 275 P.2d at 35, 25 Cal. Rptr. at 67; *Rianda*, 35 Cal. 2d at 173, 217 P.2d at 27.

124. *Spaziani*, 215 Cal. App. 2d at 682, 30 Cal. Rptr. at 666; *Shreeves*, 194 Cal. at 707, 230 P. at 451.

125. *Spaziani*, 215 Cal. App. 2d at 682, 30 Cal. Rptr. at 666; *Amen*, 58 Cal. 2d at 534, 375 P.2d at 54, 25 Cal. Rptr. at 68.

126. *Spaziani*, 215 Cal. App. 2d at 682, 30 Cal. Rptr. at 666.

127. See *id.*

128. *Id.* at 684, 30 Cal. Rptr. at 667.

and the parties limits the duty to disclose to strict compliance with the escrow instructions.¹²⁹ An escrow agent disposing of property in violation of instructions will be responsible for any resulting loss.¹³⁰ Section 2020 apparently applies to an escrow if the information is found to be within the terms of the escrow instructions.¹³¹ An escrow agent, therefore, must exercise ordinary skill and diligence in employment or be held liable for any loss caused by acts in violation of the duty.¹³² Other courts, however, have not followed *Spaziani*.

In *Gordon v. D & G Escrow Corp.*,¹³³ title to the property in escrow was held in the name of the plaintiff's estranged wife.¹³⁴ The plaintiff and his estranged wife, however, both had executed the escrow instructions.¹³⁵ When escrow closed, the escrow agent distributed all of the proceeds to the wife.¹³⁶ The court refused to recognize a cause of action for breach of fiduciary duty.¹³⁷ The defendant, however, was held liable under a breach of contract theory.¹³⁸ The court found an implied promise that, an escrow agent must disburse the proceeds of the sale to the sellers absent express instructions to the contrary.¹³⁹

In dictum, the court stated that the refusal to impose a duty to disclose was based on two factors.¹⁴⁰ First, the *Gordon* court relied upon an express disclaimer of liability in the escrow instructions.¹⁴¹ The clause disclaimed any liability for failure to inform the plaintiff of facts known to the escrow agent that were not required for compliance with the escrow instructions.¹⁴² Second, the court relied upon *Lee* to hold that the escrow agent had no duty to disclose the fraud by the estranged wife.¹⁴³ The court failed, however, to distinguish the facts in *Gordon* from the facts in *Lee*.¹⁴⁴ In *Lee*, the plaintiff alleged the escrow agent had a duty to disclose known fraud even

129. *Id.* at 682, 30 Cal. Rptr. at 666.

130. *Id.* at 682-83, 30 Cal. Rptr. at 666-67.

131. *See id.*

132. *Id.*

133. 48 Cal. App. 3d 616, 122 Cal. Rptr. 150 (1975).

134. *Id.* at 619, 122 Cal. Rptr. at 152.

135. *Id.*

136. *Id.* at 620, 122 Cal. Rptr. at 152.

137. *Id.* at 623, 122 Cal. Rptr. at 154.

138. *Id.* at 621, 122 Cal. Rptr. at 153.

139. *Id.*

140. *See infra* notes 141-46 and accompanying text.

141. *Gordon*, 48 Cal. App. 3d at 622-23, 122 Cal. Rptr. at 154.

142. *Id.*

143. *Lee*, 264 Cal. App. 2d at 163, 70 Cal. Rptr. at 380.

144. *See infra* notes 145-46 and accompanying text.

though disclosure was *not* required by the terms of the escrow.¹⁴⁵ The court held an escrow agent is not required to go beyond the terms of the escrow instructions in disclosing information.¹⁴⁶ In *Gordon*, however, the plaintiff alleged the escrow agent owed a duty to disclose information that arose within the terms of the escrow agreement.¹⁴⁷

In *Spaziani*, the court relied upon section 2020 to impose upon the escrow agent a duty to disclose information that arose within the terms of the escrow agreement.¹⁴⁸ In analyzing *Gordon*, therefore, the court should have followed *Spaziani* and was incorrect in applying *Lee* to avoid finding a fiduciary duty to disclose.¹⁴⁹

In *Schaefer v. Manufacturers Bank*,¹⁵⁰ the court again used a *Lee* analysis to deny a claim for breach of fiduciary duty. In this case, the plaintiff decided to contract directly with the purchaser.¹⁵¹ The plaintiff's purpose in dealing outside the escrow was to give up only \$35,000 in cash in favor of three trust deeds having apparent values of \$85,650.¹⁵² Later, when the deeds of trust proved worthless, however, the plaintiff alleged the escrow agent had breached the fiduciary duty.¹⁵³ The court dismissed the action stating that the loss was due to transactions entered into outside of the escrow.¹⁵⁴ The court relied on *Blackburn* and *Lee* in analyzing the duty of the escrow agent.¹⁵⁵

Significantly, the court failed to acknowledge that in *Blackburn* and *Lee* the plaintiffs alleged that the escrow agent had knowledge of the fraud.¹⁵⁶ In *Schaefer*, the plaintiff failed to allege that the escrow agent knew that the trust deeds were worthless.¹⁵⁷ The plaintiff, therefore, in effect, was arguing for extension of the fiduciary duty to include a duty to investigate and know the value of trust deeds.¹⁵⁸ In *Blackburn*, the plaintiff sought to expand the limited agency to

145. *Lee*, 264 Cal. App. at 161, 70 Cal. Rptr. at 378.

146. *Id.* at 163, 70 Cal. Rptr. at 380.

147. *See supra* notes 133-39 and accompanying text.

148. *See supra* notes 115-32 and accompanying text.

149. *See supra* notes 95-132 and accompanying text.

150. 104 Cal. App. 3d 70, 163 Cal. Rptr. 402 (1980).

151. *Id.* at 72-3 n.1, 163 Cal. Rptr. at 404 n.1.

152. *Id.*

153. *Id.* at 73, 163 Cal. Rptr. at 405.

154. *Id.*

155. *Id.* at 77, 163 Cal. Rptr. at 407.

156. *See Blackburn*, 1 Cal. App. 2d at 657, 37 P.2d at 157; *Lee*, 264 Cal. App. 2d at 161, 70 Cal. Rptr. at 379.

157. *See Schaefer*, 104 Cal. App. 3d at 76-77, 163 Cal. Rptr. at 406-07.

158. *Id.*

include a duty to disclose *known* frauds.¹⁵⁹ In *Schaefer*, the argument of the plaintiff went far beyond a limited agency theory or a duty to disclose known frauds.¹⁶⁰ The court, therefore, was correct in rejecting the argument.

Various theories of liability available against an escrow agent have been discussed.¹⁶¹ Under a breach of contract theory, an escrow agent has a duty to comply strictly with the terms of the escrow instructions.¹⁶² Under a negligence theory, an escrow agent has a duty to exercise ordinary skill and reasonable diligence in his employment.¹⁶³ Under a breach of fiduciary duty to disclose theory the law is muddled.¹⁶⁴

The reason for the confusion is evident from the case law.¹⁶⁵ The courts have failed both to distinguish the factual situations under which the arguments have been raised and to differentiate between the appropriate legal theories.¹⁶⁶ In *Blackburn* and *Lee*, the courts held the escrow agent has no duty to disclose a *known* fraud because disclosure was not required by the terms of the instructions.¹⁶⁷ In *Spaziani*, the court held that the information was within the terms of the escrow agreement.¹⁶⁸ The escrow agent, therefore, had a duty to disclose under Civil Code section 2020.¹⁶⁹

Finally, in *Schaefer*, the court held an escrow agent has no duty to disclose an *unknown* fraud if disclosure is not required by the terms of the instructions.¹⁷⁰ California courts, therefore, only recognize a breach of fiduciary duty in the *Spaziani* situation.¹⁷¹ Another jurisdiction, however, has expanded the limited agency concept to include a duty to disclose known frauds.¹⁷²

ARIZONA EXPANDS THE LIMITED AGENCY

California does not impose a duty to disclose known fraud upon

159. *Blackburn*, 1 Cal. App. 2d at 655, 37 P.2d at 156.

160. *See Schaefer*, 104 Cal. App. 3d at 77, 163 Cal. Rptr. at 407.

161. *See supra* notes 60-172 and accompanying text.

162. *See supra* notes 66-78 and accompanying text.

163. *Id.*

164. *See supra* notes 79-160 and accompanying text.

165. *Id.*

166. *Id.*

167. *See supra* notes 79-106 and accompanying text.

168. *See supra* notes 115-32 and accompanying text.

169. *Id.*

170. *Schaefer*, 104 Cal. App. 3d at 78, 163 Cal. Rptr. at 407.

171. *Id.* at 77, 163 Cal. Rptr. at 407; *see supra* notes 79-106 and accompanying text.

172. *See infra* notes 173-95 and accompanying text.

an escrow agent.¹⁷³ Prior to the 1979 Arizona Supreme Court decision in *Berry v. McLeod*,¹⁷⁴ Arizona law was consistent with California law.¹⁷⁵ In *Berry*, the plaintiff contracted to sell a parcel of land shortly before his death.¹⁷⁶ Unknown to the plaintiff, the buyer was a corporation the real estate brokers of the plaintiff established to resell the land.¹⁷⁷ The escrow agent set up simultaneous back-to-back escrows¹⁷⁸ and the brokers of the plaintiff reaped an illegal secret profit.¹⁷⁹ The escrow agent allegedly knew of the scheme.¹⁸⁰ After the plaintiff's death, his personal representative brought an action alleging negligence in the administration of the escrow and a violation of fiduciary duty for failure to disclose a known fraud.¹⁸¹

The negligence action was dismissed, but the court recognized a breach of fiduciary duty to disclose known frauds.¹⁸² The *Berry* court expanded the duty of the escrow agent by requiring disclosure of facts that, if unrevealed, would assist in perpetrating a fraud against a party to the escrow.¹⁸³ The court expressly stated that an escrow agent has no duty to investigate for fraud.¹⁸⁴ Furthermore, liability must be based upon evidence that the escrow agent had actual knowledge of the fraud and failed to disclose the information to the parties.¹⁸⁵

The Arizona Supreme Court recognized the rationale behind the reluctance of California courts, as expressed in *Lee*, to create a duty of disclosure.¹⁸⁶ The court, however, stated that fear of an increased risk of litigation is sound only up to a point.¹⁸⁷ Absent fraud, the

173. See *supra* notes 79-172 and accompanying text.

174. 604 P.2d 610 (Ariz. 1979).

175. See Comment, *Escrowees' Duty to Disclose Fraud: An Expansion of the Limited Agency Doctrine*, 22 ARIZ. L. REV. 1146, 1150 (1980).

176. 604 P.2d at 612. The court acknowledged that the facts were in serious dispute, but nonetheless assumed the allegations of the plaintiff concerning the existence of the fraud were true for the purpose of legal analysis. *Id.* at 616.

177. *Id.* at 614.

178. *Id.* A "back to back" or "double" escrow is used when a person sells property that he does not own, but has a right to purchase by virtue of a purchase agreement or option. H. Miller & M. Starr, *supra* note 50, §12:83, at 395. As long as the intermediary buyer-seller is not an agent of one of the parties, and as long as there is no other misrepresentation, the use of the "double" escrow is a legitimate transaction. *Id.* The evidence used by the court indicated that in *Berry*, McLeod's brokers were using the "double" escrow illegally since they also were acting as McLeod's agents. *Berry*, 604 P.2d at 614.

179. *Id.*

180. *Id.* at 616.

181. *Id.* at 614.

182. *Id.* at 616.

183. *Id.*

184. *Id.*

185. *Id.*

186. For a discussion of this rationale, see *supra* notes 95-106 and accompanying text.

187. See *Berry*, 604 P.2d at 616.

activities of real estate investors and speculators are legitimate.¹⁸⁸ The escrow agent has no duty to regulate the transaction so that each party receives a fair price for the property.¹⁸⁹ Nor is the agent a guardian for the uninitiated.¹⁹⁰ On the other hand, the escrow agent should not assist in the perpetration of fraud by silence.¹⁹¹

By expanding the duty to disclose to include known frauds, the Arizona court determined that protecting the parties to an escrow from fraud is part of the very purpose for which escrows are created.¹⁹² The *Berry* court, however, limited the additional protection afforded the parties by requiring only disclosure of known fraud, thereby minimizing the burden placed on the escrow agent.¹⁹³ The policy decision made by the court is that parties to the escrow should not be defrauded when the escrow agent has knowledge of the fraud.¹⁹⁴

Expansion of the limited agency to include a duty to disclose known frauds will not unduly burden the escrow agent.¹⁹⁵ The policy decision by the Arizona court indicates that protecting the parties to an escrow from a known fraud outweighs the potential increase of liability of escrow agents.¹⁹⁶ In contrast, California courts have rejected the policy decision of the Arizona courts.

RECOMMENDATIONS

California should follow the Arizona lead and expand the fiduciary duty of the escrow agent to include disclosure of known frauds. Three alternate methods to expand the traditional limited agency in California to include a fiduciary duty to disclose known fraud now will be discussed. Application of the Arizona judicial expansion in California also will be examined. Additionally, the insertion of an express duty to disclose provision in the escrow instructions will be explored as a means of modifying the existing California rule. Finally, the feasibility of expanding the fiduciary duty through legislation will be analyzed.

California cases have refused to adopt a duty to disclose on the ground that the nature of an escrow transaction cannot tolerate the

188. *Id.*

189. *Id.*

190. *Id.*

191. *Id.*

192. *See supra* notes 186-91 and accompanying text.

193. 604 P.2d at 616.

194. *Id.*

195. *Id.*

196. *See supra* notes 173-94 and accompanying text.

use of a general agency.¹⁹⁷ The rationale for this position is that a general agency creates a fiduciary relationship between the principal and the agent.¹⁹⁸ As a fiduciary, the agent assumes a duty to act primarily for the benefit of the principal in matters connected with the undertaking.¹⁹⁹ The duty includes disclosing information material to the interests of the principal.²⁰⁰ The courts have determined that the duties of the escrow agent to each party would be conflicting and, therefore, have rejected the duty to disclose.²⁰¹

Additionally, the court in *Lee* explained the potential dangers of requiring disclosure by escrow agents.²⁰² The dangers include the difficult position of an escrow agent when uncertainty exists as to whether fraud is occurring.²⁰³ Requiring the escrow agent to reveal knowledge that later proved to be inaccurate could subject the escrow agent to liability for interference with the contract of the principal.²⁰⁴ On the other hand, a failure to disclose information later found fraudulent would subject the escrow agent to suit for failure to disclose a known fraud.²⁰⁵ Furthermore, the court was concerned that requiring disclosure of known fraud effectively might discourage a reasonable person from acting as an escrow agent.²⁰⁶ Ultimately, the very purpose for which escrows originated might be defeated.²⁰⁷

The issue presented in *Lee* went beyond a duty to disclose *known* frauds.²⁰⁸ The court phrased the issue in terms of whether the escrowee is under a fiduciary duty to go beyond the terms of the instructions and notify each party of suspicious facts that *conceivably* could affect their decisions.²⁰⁹ The *Berry* decision does not require the escrow agent to investigate for suspicious facts that might affect the decisions of the parties.²¹⁰ Rather, *Berry* limited the duty to the disclosure of known frauds.²¹¹

197. See *supra* notes 79-106 and accompanying text.

198. Restatement (Second) of Agency §13, comment a (1957).

199. *Id.*

200. See, e.g., *Menzel v. Salka*, 179 Cal. App. 2d at 622, 4 Cal. Rptr. at 84; W. Prosser, *supra* note 18, at 696-97.

201. See *supra* notes 79-106 and accompanying text.

202. *Lee*, 264 Cal. App. 2d at 163, 70 Cal. Rptr. at 380.

203. *Id.*

204. *Id.*

205. *Id.*

206. *Id.*

207. *Id.*

208. See *id.* at 161, 70 Cal. Rptr. at 379.

209. *Id.* at 162, 70 Cal. Rptr. at 379.

210. *Berry*, 604 P.2d at 616.

211. *Id.*

Additionally, *Lee* states that an expansion of the duty ultimately would defeat the very purpose for which escrows originated.²¹² The purpose of creating an escrow is for the seller and buyer to have a third person handle their conflicting interests and adequately protect the rights of each party to the transaction.²¹³ Nondisclosure of known frauds results in the parties being unprotected. Since escrows are set up to provide protection, the duty to disclose should be expanded. In *Berry*, the Arizona Supreme Court extended the duty of the escrow agent to include disclosure of known fraud, thereby providing an alternative to the California rule.²¹⁴

The court in *Berry* held that the duty to disclose information not required by the escrow agreement exists only if the escrow agent *knows* that a fraud is being committed on a party to the escrow.²¹⁵ The holding does not require the escrow agent to investigate for fraud.²¹⁶ The escrow agent, therefore, faces the possibility of liability for remaining silent only in situations in which an ordinary and prudent escrowee would be put on notice of impending fraud.²¹⁷ The court emphasized the limited nature of the expansion. Nevertheless, the court determined that protection of the parties to the escrow demands that escrow agents not assist in the perpetration of fraud by silence.

An alternative to judicial adoption of a fiduciary duty to disclose known fraud is the creation of an express duty in the escrow agreement.²¹⁸ An express clause is consistent with the California reasoning that an implied duty to disclose fraud is contrary to the very nature and purpose of an escrow agreement.²¹⁹ An express duty to disclose known frauds, therefore, would retain the concept of a limited agency subject only to the terms of the escrow. At the same time, the harsh effect of known frauds going undetected by a party to the escrow would be eliminated. This proposal, therefore, would provide a cause of action to both principals against the escrow agent for breach of contract.

The problem with a contractual provision, however, is that the escrow agent furnishes an important public service and has superior

212. *Lee*, 264 Cal. App. 2d at 163, 70 Cal. Rptr. at 380.

213. *Id.*

214. *Berry*, 604 P.2d at 616.

215. *Id.*

216. *Id.*

217. *Id.*

218. See *supra* notes 79-106 and accompanying text.

219. See *id.*

bargaining power. Furthermore, the forms provided by the escrow agent are standardized. The escrow agent may be unwilling to include an express duty to disclose known frauds within the escrow agreement. Since the use of escrows is virtually indispensable in modern real estate transactions, the parties may have no choice but to use the provisions provided by the escrow agent. Once again the parties would be unprotected from known fraud.

Still another method of providing protection to the parties from known fraud is legislative action. The *Berry* rule could be codified to state expressly that the liability of an escrow agent must be based upon evidence of actual knowledge of the fraud and failure to disclose the information to the parties. Since no duty exists to investigate for fraud the limited agency merely is expanded, not abolished.

CONCLUSION

This author has examined California cases that struggle with the precise nature of the duties of the escrow agent. These courts have rejected imposing a duty to disclose upon escrow agents based on the rationale that disclosure is not required absent an express clause in the escrow instructions. Furthermore, the courts fear increased litigation against escrow agents who perform an important public service. The Arizona Supreme Court has expanded the fiduciary duty of the escrow agent to include disclosure of known frauds. The *Berry* court determined that the difficulties envisioned in California case law would not materialize. Furthermore, sound public policy dictates that escrow agents should not silently watch a party to the escrow be defrauded.

This author has established that California should follow the *Berry* expansion of the limited agency to include a duty to disclose known frauds. Possible mechanisms to achieve this expansion include judicial adoption, enactment of legislation or express contractual provisions. Creating a duty to disclose only known frauds will not destroy the nature of the escrow relationship. Escrow agents will not become guardians for the uninitiated. For the benefit of honest escrow agents and protection of the parties to an escrow, the California courts should follow the Arizona lead and impose a duty upon the escrow agent to disclose known frauds.

Karen Lee Jacobsen