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TAX AND INSURANCE ESCROW ACCOUNTS IN MORTGAGES—THE ATTACK PRESSES ON

Buchanan v. Brentwood Federal Savings and Loan Ass'n[1]

Several lending institutions in and around Pittsburg, Pennsylvania, financed the residential borrowing of various homeowners who had executed mortgages and accompanying personal bonds as security for the loans. Along with the normal principal and interest payments, the mortgagees required one-twelfth of the amount of the annual property taxes and casualty insurance premiums to be deposited monthly with the mortgagees in escrow accounts.[2] The lending institutions paid these assessments from the accumulated funds as they became due. The institutions commingled the mortgage escrow funds with general funds and invested them for their own profit, but did not pay the depositors for the use of the funds.[3] Twenty-nine individuals brought a class action against these institutions to recover the profits derived from the investment of such funds by the institutions.[4] The trial court sustained the defendants' joint demurrer and dismissed the complaints for failure to state a cause of action. On appeal, the Supreme Court of Pennsylvania held that the mortgagors' allegations of misuse of the escrow funds by the mortgagees stated a cause of action for breach of an express trust, imposition of a constructive trust, and breach of an implied contract,[5] and remanded for a trial on the merits.

The most common[6] method of challenging the legality of non-interest

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1. 457 Pa. 135, 320 A.2d 117 (1974). *See generally* Comment, *Lender Accountability and the Problem of Noninterest-Bearing Mortgage Escrow Accounts,* 54 B.U.L. REV. 516 (1974).

2. The origin of these payments dates back to the 1930's when the financial situation of thousands of people made this type of account the easiest and most convenient method of paying the taxes and insurance on their mortgaged property. At the same time these payments protected the lending institutions against tax liens which would take priority over the mortgages. *See, e.g.,* CONSUMER REP., March 1973, at 202; *Hearings on H.R. 13337 Before a Subcomm. on Housing of the House Committee of Banking and Currency,* 92d Cong., 2d Sess. 322-23 (1972); 4 AMERICAN LAW OF PROPERTY § 16.1061 (A. J. Casner ed. 1952). *See also* Comment, *Payment of Interest on Mortgage Escrow Accounts: Judicial and Legislative Developments,* 23 SYRACUSE L. REV. 845 (1972).

3. The most recent estimate of annual lost interest income to consumers amounts to over $235,000,000. Total escrow account collections themselves amount to $9.4 billion annually. United States General Accounting Office (GAO), *Study of the Feasibility of Escrow Accounts on Residential Mortgages Becoming Interest Bearing* 7 (1973).

4. Consumer protection groups have become very involved in this area of home financing. Wall Street Journal, July 21, 1972, at 12, col. 3.

5. 457 Pa. 135, 320 A.2d 117 (1974).

6. Many other theories have been advanced, without success. *See, e.g.,* Graybeal v. American Sav. & Loan Ass'n, 59 F.R.D. 7 (D.D.C. 1973) (breach of contract, unjust enrichment, usury, truth in lending, antitrust, fraud, breach of trust); Vmdenstock v. American Mortgage & Inv. Co., 363 F. Supp. 1375 (W.D. Okla. 1973) (breach of trust, unjust enrichment, truth in lending, antitrust); Stavrides v. Mellon Nat'l. Bank & Trust Co., 353 F. Supp. 1072 (W.D. Pa.), *aff'd*

bearing escrow accounts is the breach of trust theory.[7] The first appellate consideration of this theory was in *Sears v. First Federal Savings and Loan Ass'n.*[8] The plaintiffs contended that their monthly prepayments were deposits to be used for a specific purpose and were therefore sufficient to establish a trust relationship. The court disagreed, perhaps confusing the requirements of a deposit for a specific purpose with those of a special deposit.[9] The court held that the monthly payments gave rise only to a debtor-creditor relationship, not a trust. It is to be noted that the *Sears* decision was based on the court's interpretation of the specific mortgage instrument in issue. A major portion of the court's opinion centered on the instrument's express language relating to the monthly prepayments. The form used contained three possible wordings, of which one was to be selected at the option of the lending institution. The language actually chosen was in contrast to specific trust language contained in another of the available options.[10] Further construction of the agreement's language led the court to regard the deposits as being pledged against the main indebtedness; that is, the escrow funds were construed merely to represent payments on a debt owed to the institution. The exact language of the contract, as alleged in the complaint, proved to be a bar to the plaintiffs' recovery.

Carpenter v. Suffolk Franklin Savings Bank[11] went a step further than *Sears* by "recognizing the special purpose nature of these prepayments [tax-escrow funds] and the resulting trust relationship."[12] *Carpenter* was the first appellate decision to hold that the mortgagor's trust theory stated a cause of action.[13] Unlike *Sears,* the *Carpenter* decision was not

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per curiam, 487 F.2d 953 (3d Cir. 1973) (antitrust, truth in lending, usury, unjust enrichment, breach of fiduciary duty).

7. The payments are considered as creating a trust relationship between mortgagor and mortgagee under this theory. Ulbrict, *Impound Accounts and After,* 28 BUS. LAW. 203 (1972).

8. 1 Ill. App. 3d 621, 275 N.E.2d 300 (1971).

9. Specific property deposited with a bank and earmarked for exact return is a special deposit. The relationship created is one of bailor-bailee. A deposit for a special purpose requires only that the designated purpose of the deposit be strictly adhered to by the bank and a trust is thereby created. Annot., 31 A.L.R. 472 (1924); *cf.* 5 A. SCOTT, THE LAW OF TRUSTS § 530 (3d ed. 1967). The *Sears* court believed that the payments must be segregated and earmarked before a trust could arise. However, these are not requirements for a special purpose deposit. *See* Comment, *The Attack Upon the Tax and Insurance Escrow Accounts in Mortgages,* 47 TEMP. L.Q. 352, 353-58 (1974).

10. The options in regard to the escrow payments were that they: (1) be held in trust by it without earnings for the payment of such items; (2) be carried in a borrower's tax and insurance account and withdrawn by the lender to pay such item; or (3) be credited to the unpaid balance of said indebtedness as received.

11. ——— Mass. ———, 291 N.E.2d 609 (1973).

12. Comment, *supra* note 9, at 359.

13. Only a New York Small Claims Court has gone farther. It allowed a mortgagor to recover profits derived from the investment of the escrow funds on a breach of fiduciary duty theory. Tierney v. Whitesone Sav. & Loan Assn, 353 N.Y.S.2d 104, 75 Misc. 2d 284 (Small Claims Ct. 1974).

based on an interpretation of the specific language of the mortgage and loan agreements in question. The language of these instruments was not specifically set forth in the pleadings and therefore was not before the court.[14] The allegations pertinent to the decision set forth only that the mortgagors made monthly payments into escrow in order to pay their property taxes, that the bank commingled the funds with its own resources, invested the funds for a profit, and refused to render these earnings to the mortgagors.[15]

To support its holding, the *Carpenter* court relied on two lines of trust theory: the so-called "*ABC*" case and two special deposit cases. The former analysis is based on the decision of *In Re Interborough Consolidated Corp.*[16] In that case the United States Court of Appeals for the Second Circuit said that when *A* gave money to *B* to be delivered to *C*, a trust arose in favor of *C*.[17] Under the facts of *Carpenter*, *A* is the mortgagor and *B* the lending institution which pays the taxes to the city, *C*. If the bank refused to remit the mortgagor's tax payments to the city, the "*ABC*" theory would allow the city to sue the bank for a breach of trust.[18] However, the primary function of this theory is to protect creditors from middlemen, not to allow mortgagors to recover the profits derived from a mortgagee's wrongful use of escrow funds.[19]

The second theory involves the creation of a trust relationship through the existence of special deposits. This relationship arises when money is deposited with a bank to be held by it separate from its own assets.[20] But the bankruptcy cases relied on in *Carpenter* in support of this theory are of doubtful precedential value. The imposition of a trust to preserve a special depositor's rights against unsecured creditors in a bankruptcy case does not, *a priori*, support the finding of a trust where mortgagors are seeking an accounting of profits from mortgagees.[21]

Surprisingly, the *Carpenter* court did not indicate the specific form of trust that may have been created. This is in contrast to the distinction between express and implied trusts made by the *Sears* court. There it was held that no express trust could arise, because of the nature of the express language of the agreements. The *Sears* court proclaimed:

> Although the term "implied trust" has been used to designate an express trust arising from the construction of language in a document, it seems to us that it is preferable to define the trust which would arise in such situations as an express trust.[22]

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14. ____ Mass. at ____, 291 N.E.2d at 611.
15. *Id.* at ____, 291 N.E.2d at 613-14.
16. 288 F. 334 (2d Cir.), *cert. denied*, 262 U.S. 752 (1923).
17. *Id.* at 347, *citing* McKee v. Lamon, 159 U.S. 317, 322 (1895).
18. Comment, *supra* note 1, at 522-23.
19. *Id.* at 521-22.
20. 5 A. Scott, The Law of Trusts § 530 (3d ed. 1967).
21. Comment, *supra* note 1, at 522.
22. 1 Ill. App. 3d at 627, 275 N.E.2d at 303.

Because the complaint before the *Carpenter* court did not assert the express language of the agreement, the trust in issue should have been considered an implied trust.

It has been suggested that a resulting trust most properly conforms to the facts of *Carpenter*.[23] This is a logical position, even though none of the three traditional classes of resulting trusts is precisely applicable.[24] In contrast to an express trust, which is created by the settlor's external expression of intention, a resulting trust exists if the circumstances show an absence of intention on the part of a transferor to give the beneficial interest in property to one who has received legal title.[25] In the tax escrow account area, it can be argued that the mortgagor did not intend to allow the lending institutions the beneficial use of his money. Therefore, any profits derived from the use thereof should result back to the mortgagor. The intent of the escrow payments is to protect the mortgagee's security interest, not to increase his income.

The *Carpenter* court noted that the intention of the parties determines the existence of a trust.[26] However, *Carpenter* did not consider the merits of a constructive trust theory. Unlike an express trust or resulting trust, a constructive trust is remedial in nature.[27] A creature of equity, a constructive trust does not arise by virtue of agreement or intention.[28]

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23. A resulting trust theory may provide a tactical advantage to the class action lawsuit which typifies tax escrow account litigation. As the circumstances surrounding the payments are instrumental in the determination of the mortgagor's intention and therefore the applicability of a resulting trust, the similarity of circumstances arising from the dealings of one lending institution facilitates the class treatment. A constructive trust theory has similar advantages. As an advocate of the resulting trust theory, one has several possible contentions. He can point to the limited purpose of the escrow payments and to other factors leading to a strong inference that the mortgagor intended to keep the beneficial interest in his tax payments. "The mortgagor could require the bank to rebut this inference by showing, perhaps, that it was the bank's policy and practice to raise this matter routinely with prospective mortgagors. If the bank cannot demonstrate that its usual practice was to inform borrowers that they would not receive any interest or earnings from the bank's investment of their tax excrow payments, it will be difficult for the bank to argue effectively against the finding of a resulting trust." Without such disclosure it will be difficult to prove that the mortgagors desired to give away any beneficial interest in their payments to the mortgagee. Comment, *supra* note 1, at 528-29.

24. Traditionally, resulting trusts have been found where an express trust fails, where an express trust is fully performed and there remains a surplus in the trust estate, and where property is purchased with funds supplied by *A*, but legal title is transfered to *B*. *See* RESTATEMENT (SECOND) OF TRUSTS §§ 411, 430, 440 (1959). The last kind of resulting trust is commonly called a "purchase money resulting trust." *See* G. & G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 454 (3d ed. 1964). It has been suggested that the only traditional resulting trust similar to that which may exist in *Carpenter* is the purchase money resulting trust. *See* Comment, *supra* note 1, at 525-29.

25. 5 A. SCOTT, *supra* note 20, § 404.1.

26. _____ Mass. at _____, 291 N.E.2d at 614.

27. 89 C.J.S. *Trusts* § 139 (1955).

28. *See* RESTATEMENT (SECOND) OF TRUSTS ch. 12, at 326 (1959) (introductory note to topic 1).

Buchanan marks the most significant advancement of the trust theory by an appellate court. Only the *Buchanan* court treated the constructive trust theory as stating a cause of action. Not really a legal trust at all, a constructive trust is an equitable remedy imposed to prevent the unjust enrichment of one party at the expense of another.[29]

In seeking the imposition of a constructive trust, the plaintiffs in *Buchanan* contended that a confidential relationship arose between themselves and the mortgagees as a result of the relative position of the parties to the mortgage transaction.[30] As the primary basis for their cause of action, the plaintiffs asserted that the mortgagees' retention of the escrow fund profits had breached this confidential relationship. The court stated that proof of the existence of a confidential relationship is sufficient justification for imposing a constructive trust, unless the party with the dominant position can prove "by clear and satisfactory evidence" that the contract was not tainted by his superior bargaining position.[31]

A second theory offered by the plaintiffs in support of the imposition of a constructive trust was based on the alleged existence of an agency relationship between the mortgagors and mortgagees. If an agent makes an unauthorized use of his principal's money for his own advantage, a court may appropriately decree the equitable remedy of a constructive trust.[32] The court agreed with this reasoning, stating that the plaintiffs could prevail on this theory if it could be proven on remand that the mortgage agreement contemplated such an agency relationship.[33]

Unjust enrichment was the third theory proposed by the plaintiffs as a basis for declaring the mortgagees constructive trustees of the earned profits. In reply to this proposal, the court stated that the fundamental question was whether "the conscience of equity" would conclude that the mortgagees would be unjustly enriched should they be allowed to keep the profits from the escrow funds.[34] In general, equity will impose a constructive trust when property has been acquired in such circumstances that the one who holds the legal right to the property ought not in equity and good conscience retain the beneficial interest therein.[35] It is well-settled that this remedy will be imposed whenever justice or the need for fair dealing warrant it.[36]

The dissent in *Buchanan* believed that the complaint did state a cause of action on the constructive trust theory, but also said that the complaint

29. 89 C.J.S. *Trusts* § 139 (1955).
30. A fiduciary or confidential relationship may arise from the relative standing of the parties to a transaction. Triesler v. Helmbacher, 350 Mo. 807, 817, 168 S.W.2d 1030, 1036 (1943).
31. 457 Pa. 135_____, 320 A.2d 117, 127 (1974).
32. RESTATEMENT (SECOND) OF AGENCY §§ 13, 387, 388 (1958).
33. 457 Pa. at _____, 320 A.2d at 128.
34. *Id.*
35. 5 A SCOTT, THE LAW OF TRUSTS § 462 at 3413 (3d ed. 1967).
36. *Id.*

itself violated a Pennsylvania rule of civil procedure requiring a complaint to state specifically whether any claim set forth therein is based upon a writing.[37] This objection underscores an advantage of a constructive trust theory. The mortgage agreement itself can destroy the express trust theory because the language of the agreement can be drafted to negate expressly any intention to create a trust. A constructive trust is not based upon the intent of the parties and no amount of careful draftsmanship can circumvent this theory.

Missouri courts have set forth standards for the imposition of a constructive trust applicable to mortgage escrow account litigation. It has been held that a confidential or fiduciary relationship exists whenever confidence is reposed by one party and the other exerts a resulting influence or superiority on the reposing party.[38] The origin of this confidence and its resulting influence are immaterial.[39] However, there must be evidence of some inequality, dependence, or weakness coexisting with the granting of this confidence before a constructive trust will be imposed.[40] It is of no consequence that the constructive trustee acted in good faith or without actual intent to defraud.[41]

The *Buchanan* rationale illustrates the inherent flexibility of established trust and constructive trust doctrines. Before relying on the *Buchanan* case, however, a thorough examination of the mortgage agreements in question is necessary, because mortgagors filing similar actions should expect close judicial scrutiny of these agreements. Further decisions in this area are likely to be on a case by case basis.

The most satisfactory remedy to the problem of tax and insurance escrow accounts lies in recourse to the legislatures. A recent New York statute requires the payment of interest at a rate to be established periodically by a Banking Board, but in no event less than two percent per annum.[42] Additionally, the legislation prohibits the imposition of service charges on escrow accounts. The latter provision is a substantial victory for the potential mortgagor entering the housing market, because the increased costs of "administration" of the system may well have been passed on to him in its absence. This "passing on" result is inherent in a Massachusetts law which requires a mortgagee to pay interest in a manner determined by the mortgagee.[43] The net effect of this latter provision may be to require future borrowers to pay for the administrative costs incident to the maintenance of an escrow account, a service that has traditionally been provided free of charge. Nevertheless, resolution of the consumer's

37. 457 Pa. at ——, 320 A.2d at 128.
38. Trieseler v. Helmbacher, 350 Mo. 807, 168 S.W.2d 1030 (1943).
39. *Id.* at 817, 168 S.W.2d at 1036.
40. Cohn v. Jefferson Savings and Loan Ass'n, 349 S.W.2d 854, 859 (Mo. 1961); Gates Hotel Co. v. C.R.H. Davis Real Estate Co., 331 Mo. 94, 52 S.W.2d 1011 (1932).
41. Swon v. Huddleston, 282 S.W.2d 18 (Mo. 1955).
42. N.Y. BANKING LAW § 119 (McKinney 1974).
43. MASS. LAWS ANN. ch. 183, § 61 (Supp. 1974).