The Improper Use of Tax and Insurance Escrow Payments by Mortgages

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COMMENT

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A particularly important consideration for all lenders is to secure their loans. With insufficient security, a borrower's defaults can endanger a lender's livelihood. Although real estate mortgagees can protect themselves against ultimate loss by the process of foreclosure, this protection can prove inadequate if other liens, such as tax or water company liens, attach and obtain priority over the mortgage or encumber the resale of the property. Additionally, if property is uninsured and destroyed by some catastrophe, foreclosure would be futile. Because of these dangers, mortgagees often require mortgagors to make monthly payments to the lender equal to one-twelfth of the estimated annual taxes, assessments, insurance premiums, and other real estate charges in advance of their due date. When these bills become due, the lender pays them on behalf of the mortgagor. This process is the soundest way for mortgagees to protect their interest in the collateral for the loan.

Two methods for collecting and holding these monthly payments have been used extensively by lenders. Under the earlier method, that of capitalization, the monthly payments were credited to the mortgage balance. When the lender paid bills of the mortgagor, the mortgage balance was increased accordingly. The more popular, current device is the noninterest-bearing escrow or deposit account which provides for these payments to be held by the mortgagee without reducing the borrower's mortgage balance.

1. Tax and utility company liens may lead to a forced public sale of the property in order to satisfy the lien. The remainder of the sale price could be claimed by the mortgagee. See G. Osborne, Handbook on the Law of Mortgages 425-27 (1970). See also Uniform Commercial Code § 9-301 (priority of nonstatutory lien creditor over Article 9 unperfected security interest).

2. At common law, the mortgagee was required to pay outstanding taxes and could clear liens from the record. The amount expended could be added to the mortgage balance. 2 L. Jones, A Treatise on the Law of Mortgages of Real Property § 883 (8th ed. 1928). See Comment, Payment of Interest on Mortgage Escrow Accounts: Judicial and Legislative Developments, 23 Syracuse L. Rev. 845, 846-47 (1972). Under the present escrow system, there are never unpaid bills since the money to cover these expenses is paid in advance.

3. See Comment, supra note 2, at 848-49. During the late 1960's, lenders began
the capitalization method, under which the mortgagor gets the benefit of a lower mortgage balance at the time that interest on the loan is calculated, the escrow method deprives the mortgagor of the use of his money, does not lower the mortgage balance, and, in effect, gives the lender a free loan. 4

This article will examine the escrow method and the various litigious assaults upon its operation. Courts have been presented with four major arguments against the use of the escrow device: that it violates the Truth in Lending Act; 5 that it constitutes a tying arrangement in violation of the

4. The available statistics are unclear as to the benefits for borrowers and lenders under either method. Estimates range from hundreds of millions of dollars lost by borrowers because of the escrow practice, see Note, Lender Accountability and the Problem of Noninterest-Bearing Mortgage Escrow Accounts, 54 B.U.L. Rev. 516, 517 (1974); Comment, supra note 2, at 850 n.28, to bankers' claims that both the escrow or the capitalization method are unprofitable since the maintenance costs offset profits earned. See Comments Folder 75-81 to Proposed Amendment of 12 C.F.R. § 545.6-11 (1974), Federal Home Loan Bank Board (file closed March 4, 1975); Note, 54 B.U.L. Rev., supra, at 517, 533-34; Comment, The Attack Upon the Tax and Insurance Escrow Accounts in Mortgages, 47 Temp. L.Q. 352, 368 (1974). See also Raab v. Bowery Sav. Bank, 77 Misc. 2d 1054, 355 N.Y.S.2d 748 (N.Y. County Small Cl. 1974); McKully v. Rader, 27 Md. App. 350, 340 A.2d 374 (1975). McKully adds credence to the higher estimates of profits derived by lenders. The case involved the bankruptcy of a limited partnership which had an escrow account containing $17,000 for taxes and insurance at the time-of bankruptcy. Obviously, a lender with free use of funds in sums as great as this could profit greatly by investing for his own benefit. At least one court has approved a lender's retention of profits earned from these escrow accounts. After examining the practical necessity for maintaining escrows, the court in Foster v. Maryland State Sav. & Loan Ass'n, 369 F. Supp. 843 (D.D.C. 1974), stated:  

Moreover, there is a strong public policy which favors the practice of collecting in advance real estate taxes and insurance premiums. It extends to the borrower a useful and desirable service, much in the same manner that the Federal and state governments "withhold" taxes to insure that funds are available when the taxes become due. Defendants should not necessarily be expected to perform this service gratis. That they did so in the past does not render discontinuance unconscionable. Whether they do so in the future will be determined by the Federal Home Loan Bank Board and the competitive forces of the market place.


Sherman Act and Clayton Act that lenders have conspired to restrain trade in violation of the Sherman Act; and that lenders breach their fiduciary duty if they commingle the escrow accounts for their own use and benefit. The first three claims are based on federal law and are considered together. The fourth claim is based on common law and is examined separately.

Before proceeding to a discussion of the substantive issues outlined above, however, it is necessary to briefly elucidate the rationale underlying these payments for tax and insurance and the extent to which this practice is utilized. Authorization to collect monthly payments from the mortgagor has been conferred on mortgagees primarily by the Federal Home Loan Bank Board (FHLBB), which governs all federal savings and loan associations and other member institutions. The need for more adequate mortgage security became apparent during the 1930's when homeowners found taxes and property insurance especially difficult to afford. Banks began requiring monthly prepayments in an attempt to curtail the increasing number of tax lien foreclosures. Since 1958, the FHLBB's regulation has stated that a federal association "may require" these monthly payments. As is apparent from the cases discussed below, many lending institutions have exercised this power. In addition, the Veterans Administration (VA) and the Federal Housing Administration (FHA) regulations mandate the establishment of escrow accounts for monthly payments. Due to the various permissive and mandatory regulations, the practice is sufficiently widespread to affect a significant number of mortgage institutions.

I. Federal Court Jurisdiction: Truth in Lending and Antitrust Claims

Federal court jurisdiction over tax and insurance escrow cases obtains when a plaintiff makes truth in lending and antitrust claims; challengers

11. 38 C.F.R. § 36.4512 (1975) (Veterans Administration); 24 C.F.R. § 203.23(a) (1975) (Federal Housing Administration).
of the escrow device have often urged the court to take pendent jurisdiction over the state based claim of breach of fiduciary duty.\textsuperscript{18} Nearly all of these actions have been dismissed in pretrial proceedings, however.\textsuperscript{14}

Plaintiffs relying on the Truth in Lending Act assert that the monthly payments are actually finance charges in disguise; failure to disclose these finance charges arguably violates the Act.\textsuperscript{15} The federal courts, however, have uniformly rejected this argument, noting that provisions in both the Truth in Lending Act\textsuperscript{16} and Regulation Z\textsuperscript{17} promulgated thereunder, specifically exempt such payments from disclosure.\textsuperscript{18} The language of the Act and Regulation Z is indeed relevant; the Act exempts from disclosure "escrows for future payments of taxes and insurance,"\textsuperscript{19} and Regulation Z exempts "[a]mounts required to be placed or paid into an escrow or trustee account for future payments of taxes, insurance, and water, sewer, and land rents."\textsuperscript{20}

If in drafting the Truth in Lending Act Congress intended that "escrow" be construed in its strict legal sense,\textsuperscript{21} the exemption from disclosure is logical,
because while the Act contemplates disclosure of profitmaking charges, a true escrow requires the lender to segregate and hold the funds without profiting therefrom.\textsuperscript{22} It is thus arguable that the Act's exemption applies only to true escrow accounts. But when monthly payments, though termed escrow accounts, are actually collected by the lender to derive profits, they are not true escrows and should not be accorded exempt status by the courts.\textsuperscript{23} Otherwise, the Truth in Lending Act's mandate that finance charges be disclosed would be circumvented.

The antitrust tying arrangement allegations, which contend that a lender is tying together escrow accounts and mortgage loans, have a sounder legal basis than do the truth in lending claims. The escrow tying arrangement cases argued in federal courts thus far have involved motions to dismiss and motions for summary judgment. Although the courts in all of these cases have rejected the truth in lending claims,\textsuperscript{24} the antitrust claims have been remanded for trial without a decision on the merits; the state law claims have been dismissed on jurisdictional grounds.\textsuperscript{25}

Tie-ins have been defined as "an agreement by a party to sell one product [tying product] but only on the condition that the buyer also purchases a different (or tied) product, or at least agrees that he will not purchase that product from any other supplier."\textsuperscript{26} Such arrangements may be subject to attack under section 3 of the Clayton Act and section 1 of the Sherman Act. The Clayton Act makes unlawful only those tying arrangements involving "goods, wares, merchandise, machinery, supplies and other commodities . . . ." which may have the effect of substantially lessening competition or tending to create a monopoly.\textsuperscript{27} In contrast, the Sherman Act makes unlawful every tying arrangement which is an unreasonable restraint of trade.\textsuperscript{28} An alternative means of establishing an antitrust violation is to prove that lenders have conspired to restrain trade by agreeing to offer mortgagors only noninterest-bearing escrow accounts.\textsuperscript{29} Arguably, the escrow arrangement violates

\textsuperscript{22} See p. 117 infra.
\textsuperscript{23} See cases discussed pp. 117-19 infra ("escrow" broadly construed).
\textsuperscript{24} See cases cited note 18 supra.
\textsuperscript{25} Pendent jurisdiction over the state based claim has been rejected, generally as not arising out of a common nucleus of operative fact with the antitrust claims. See, e.g., Umdenstock v. American Mortgage & Inv. Co., 495 F.2d 589 (10th Cir. 1974) (breach of fiduciary duty claim dismissed).
\textsuperscript{28} Id. § 1 (1970). See also note 29 infra.
\textsuperscript{29} Id. See pp. 109-15 infra. This theory of conspiracy to restrain trade is often ap-
one or both of these theories, as is apparent from an examination of the escrow cases brought in federal court.

In considering the antitrust charges, a threshold issue is whether there exists sufficient contact with interstate commerce for the federal court to exercise subject matter jurisdiction. In *Stavrides v. Mellon National Bank & Trust Co.*, the court examined the substantive antitrust arguments and concluded that, in light of the normal flow of banking business, the arrangement had a significant enough connection to interstate commerce to warrant jurisdiction, even though the mortgage loans were made primarily intrastate. The court further stated that the tying arrangement alleged to exist between the escrow and the mortgage was conceivable but somewhat strained. The parties were ordered to proceed with discovery on the antitrust issues.

A fuller discussion of the conspiracy and tying arrangement antitrust claims appears in *Kinee v. Abraham Lincoln Federal Savings & Loan Association*. Plaintiffs there alleged that all of the lending institutions in the Philadelphia area had conspired to switch from the capitalization to the escrow method, and that the escrow and mortgage practice was an illegal tying arrangement in restraint of trade. Although one-third of the 177 defendants were dismissed because they did not use the escrow method, the court nevertheless stated that the alleged conspiracy might constitute a provable antitrust violation because of the plaintiffs' plausible contention that most of the mortgage lenders conspired to eliminate the capitalization method from the market. In addition, the court determined that the tie-in allegations were conceivable because the escrow arrangement and the mort-


30. 353 F. Supp. 1072 (W.D. Pa.) aff'd, 487 F.2d 953 (3d Cir. 1973). The court retained jurisdiction over the antitrust claims, but dismissed the truth in lending and state claims.

31. 353 F. Supp. at 1075. The court stated:

[W]e will not assume at this stage of the suit that the defendants do not receive some increase in assets or profits as a result of this residential mortgage business and that these increased assets and/or profits do not make their way through the normal course of the banking business into interstate commerce. *Id.*


33. Apparently, the plaintiffs had joined every lending institution listed in the phone book without investigating whether they used the escrow method. As a result, the judge ordered the plaintiffs' attorneys to pay to the 46 dismissed defendants the amount of legal expenses incurred in defending the suit. 365 F. Supp. at 982-83.
gage loans were separate products susceptible of being tied together. Consequently, further discovery, not dismissal, was deemed most appropriate under the circumstances.

A less difficult to prove conspiracy concept was asserted before the United States Court of Appeals for the Tenth Circuit in Umdeonstock v. American Mortgage & Investment Co. Instead of charging that an overt conspiracy existed among lenders, the plaintiffs urged that mortgagees utilizing the escrow device were guilty of "conscious parallelism," a vague antitrust concept that falls short of conspiracy but entails more than mere independent action in restraint of trade. In discussing this allegation, the court noted that summary judgment in antitrust cases has met with judicial disfavor because the evidence is often exclusively in the defendant's hands. As a result, the court ruled that a plaintiff should be afforded at least the opportunity to conduct discovery before summary judgment on the conspiracy issue is considered.

While these decisions have not reached the merits of the antitrust claims, they indicate that the alleged violations may be substantiated. An examination of the tie-in arrangement theory is helpful in determining the possible outcome of a trial predicated on such a theory; discussion of "conscious parallelism" will aid in deciding whether the lenders' behavior falls within this antitrust conspiracy concept.

Before exploring the standards of illegality for tying arrangements, however, it is necessary to determine the applicability of the Sherman and Clayton Acts to escrow tying arrangements. While such arrangements are clearly within the scope of the Sherman Act, which applies to every contract in restraint of trade, there is considerable question whether a mortgage loan as the tying product and an escrow deposit as the tied product are "commodities" subject to the Clayton Act.

35. 495 F.2d 589 (10th Cir. 1974). The court affirmed summary judgment for the defendant on a truth in lending claim, but remanded the antitrust claims.
37. The language of section 1 covers "[e]very contract, combination . . . or conspiracy in restraint of trade," and thus, unlike section 3 of the Clayton Act, places no limits upon the types of tied or tying products which are potentially subject to its provisions. 15 U.S.C. § 14 (1970).
A. Tying Agreements

Mortgage Loans as a "Commodity" Within the Clayton Act. The leading case on the question of whether home loan money can be a tying product which is subject to the Clayton Act is United States v. Investors Diversified Services, Inc., in which it was alleged that the requirement that borrowers permit only the mortgagee to write, place, or sell hazard insurance for property constituted an illegal tying arrangement. The court looked to the wording of section 3 of the Clayton Act to decide "whether a loan of money secured by a real estate mortgage constitutes a lease or a sale or a contract for sale of goods, wares, merchandise, machinery, supplies, or other commodities . . ." After deciding that a loan is not a sale in the usual business sense, the court employed the principle of *ejusdem generis* in interpreting the Clayton Act provision. The court concluded that since the phrase "other commodities" must be read to mean commodities of the same class or kind as goods, wares and merchandise, the term does not include money, which in the court's view constitutes a "medium of exchange." By ruling that there was no section 3 violation, the court avoided the question of whether the insurance writing was covered in the words of the statute or if, under the statute, it could be viewed as a tied product.

The Investors Diversified Services decision was soundly criticized by some commentators. Although no decisive authority existed for the proposition that money was covered by the antitrust statute, one of the decision's critics

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39. Id. at 647.
40. *Ejusdem generis* is the principle of statutory construction which requires that when a general term is used at the end of a series of specific terms, the general term shall be interpreted to include only items of the same kind or class as those specifically enumerated. See United States v. Chase, 135 U.S. 255 (1890); 2A C. Sands, Sutherland Statutory Interpretation §§ 47.17-47.22 (4th ed. 1973).
41. 102 F. Supp. at 648.
42. See, e.g., 52 Colum. L. Rev. 1066 (1952). The author charged that the decision was based on unsound authority, namely, Curtis Publishing Co. v. FTC, 270 F. 881 (3d Cir. 1921), aff'd, 260 U.S. 568 (1923). Curtis was an agency case involving a contract between principal and agent. It bears no relation to the loan contract at issue in Investors Diversified Services.
looked to "[t]he legislative history of the Clayton Act [which] indicates that, had the specific question been raised, Congress would have considered money a commodity within the meaning of § 3." No case has directly raised this issue again. However, the Justice Department continued to press its Sherman Act claim, resulting in a consent decree which enjoined Investors Diversified from maintaining the tying arrangement; thereafter, it took the official position that tying sales of hazard insurance with mortgage loans was a prima facie restraint of trade.

In addition, the Supreme Court in *Fortner Enterprises, Inc. v. United States Steel Corp.*, while considering whether an alleged tie-in of credit to the sale of prefabricated homes could violate section 1 of the Sherman Act, stated that "... money is a fungible commodity—like wheat or, for that matter, unfinished steel ..." Thus, despite the *Investors Diversified Services* conclusion, it is apparent from Justice Black's statement that the Supreme Court could find that commodities include mortgage money loans.

*Deposit Services as a "Commodity" within the Clayton Act.* Equally controversial is the issue of whether the bank deposit service is a commodity. Many cases have followed the restrictive interpretation established by *Investors Diversified Services*, defining a commodity as a tangible product, distinguishable from a service. Banking, and the escrow method in particular, has been characterized as a service by courts and commentators, making

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43. 52 COLUM. L. REV. 1062, 1068 (1952).
46. Id. at 509.
47. "Commodities" have been found not to include the following "services": mutual funds, Baum v. Investors Diversified Serv., Inc., 409 F.2d 872 (7th Cir. 1969); the privilege of the right to broadcast vocally, Tri-State Broadcasting Co. v. United Press Int'l, Inc., 369 F.2d 268 (5th Cir. 1966); bus transportation, Fleetway, Inc. v. Public Serv. Interstate Transp. Co., 72 F.2d 761 (3d Cir. 1935); loans to theaters to induce purchase of products, Wendkos v. ABC Consol. Corp., 379 F. Supp. 15 (E.D. Pa. 1974); sale of admission tickets, Kennedy Theater Ticket Serv. v. Ticketron, Inc., 342 F. Supp. 922 (E.D. Pa. 1972).
it unlikely that a court would regard bank activities as commodities. However, other courts have found the sale of a product tied to a mandatory services contract to be an illegal tie-in. At least one authority states that "[e]ither or both of the tying and tied 'products' may be a service," and the Supreme Court, when it found in Fortner Enterprises that credit had been illegally tied in, stated in a different context that it could "find no basis for treating credit differently in principle from other goods and services." Thus, services are arguably within the commodities definition, and as such, they are proper subjects for Clayton Act enforcement.

**Tying Arrangement Standards.** Although at one time the Supreme Court indicated that the test of illegality for a tying arrangement under the Sherman Act was more stringent than that of the Clayton Act, any distinction between the two appears to have been eviscerated by later decisions.

A violation of the Sherman and Clayton Acts requires that the defendant have some dominance in the relevant field in order for the tie-in to constitute a restraint of trade. Occasionally, this dominance is called "leverage." Two major Supreme Court decisions have established the applicable standard for dominance or leverage. In the first, *Northern Pacific Railway Co. v. United States,* Justice Black, writing for the majority, stated:


50. Pearson, supra note 26, at 627 n.5. The term "product" might imply that it is limited to tangible, saleable items. Some cases, however, indicate a broader, nonrestrictive definition for "product" that includes services. See note 48 supra.

51. 394 U.S. at 509.

52. See, e.g., Times-Picayune Publishing Co. v. United States, 345 U.S. 594 (1953). The Court stated that a substantial lessening of competition would be inferred under section 3 of the Clayton Act when the seller enjoys a monopolistic position in the tying product's market or when the arrangement restrains a substantial volume of commerce in the tied product, but that section 1 of the Sherman Act would ban such an arrangement only when both conditions were satisfied. Id. at 608-09.

53. See, e.g., Northern Pac. Ry. Co. v. United States, 356 U.S. 1 (1958), in which the Court cut back on the dual standard of Times-Picayune, see note 52 supra, by stating that a tying arrangement would violate section 1 of the Sherman Act if the seller enjoyed sufficient economic power to appreciably restrain free competition in the tied product, thus eliminating the requirement of "monopoly power" or "dominance" before per se unreasonableness under section 1 could be found. Id. at 11.


55. "Leverage" is the economic power necessary to impair freedom of choice and has been explained by one authority as "nothing more than the use by a seller of a particular combination of resources—a combination which establishes his position in the market—to secure the most favorable terms he can from his customers; that is, he is maximizing his profits." Pearson, supra note 26, at 642.

56. 356 U.S. 1 (1958). Northern Pacific Railway sold deeds and entered leases
Indeed "tying agreements serve hardly any purpose beyond the suppression of competition." . . . They deny competitors free access to the market for the tied product, not because the party imposing the tying requirements has a better product or a lower price but because of his power or leverage in another market. . . . They are unreasonable in and of themselves whenever a party has sufficient economic power with respect to the tying product to appreciably restrain free competition in the market for the tied product and a "not insubstantial" amount of interstate commerce is affected.57

A number of years later, in *United States v. Loew's, Inc.*, 58 the Court broadened the concept of economic power beyond the size and power of the defendant by stating that "even absent a showing of market dominance, the crucial economic power may be inferred from the tying product's desirability to consumers or from uniqueness in its attributes."59

Although these two decisions formed the basic test for deciding whether an alleged tie-in constitutes an antitrust violation, the applicable standard apparently required further clarification. In *Fortner Enterprises*, the Court attempted to set a method of application for the standard by suggesting that sufficient economic power does not depend on the defendant's ability to monopolize a total market for the tied product. Dominance is to be tested primarily by a new standard: "... the proper focus of concern is whether the seller has the power to raise prices, or impose other burdensome terms such as a tie-in, with respect to any appreciable number of buyers within the market."60

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57. Id. at 6.
58. 371 U.S. 38 (1962). The defendant movie company sold or licensed patented feature films to television stations, upon the condition that the station accept a package of one or more unwanted or inferior films. This block booking was deemed a restraint on trade because it tied unwanted movies to the sale of unique and desirable films.
59. Id. at 45.
60. 394 U.S. 495, 504 (1965). In *Fortner Enterprises*, the United States Steel Home Credit Corporation extended credit (an intangible commodity) only if the purchaser bought a prefabricated house from United States Steel; this was held to be an illegal tying arrangement. Justice Black, writing for the majority, stated that sufficient economic power does not . . . require that the defendant have a monopoly or even a dominant position throughout the market for the tying product. Our tie-in cases have made unmistakably clear that the economic power over the tying product can be sufficient even though the power falls far short of dominance and even
When the standard established by *Northern Pacific* and *Loew's*, as clarified in *Fortner Enterprises*, is applied to the escrow method, the focus centers on a combination of factors: the extent to which the escrow method is utilized, whether those practicing the method are in such a position in the mortgage market that they can tie in the escrow service, and whether the mortgage offers of the mortgagees are unique or desirable to consumers. It is important to note, according to the *Fortner Enterprises* test, that the mortgagee need not control the whole market, but only an appreciable number of buyers.

One court has considered the argument that the escrow method satisfies the per se standard of *Fortner Enterprises*. In *Spens v. Citizens Federal Savings & Loan Association*, the United States District Court for the Northern District of Illinois granted the defendants’ motion to dismiss after deciding that the defendants lacked sufficient economic power to control the market. In dismissing the complaint, the court questioned the effect of the escrow practice on interstate commerce, and considered the complaint substantively deficient because each defendant was alleged to have a tie-in but no individual defendant was alleged to have sufficient economic power to impose the tie-in. Since the borrowers could obtain mortgages elsewhere without the escrow, the court concluded that there was no restraint on the market. Significantly, the court failed to follow the general guidelines for permitting preliminary discovery in antitrust cases: examination of the number of borrowers, uniqueness of the mortgage offers, and inquiries into the market power of the defendants. It is possible that such inquiries might lead another court to reach a contrary conclusion.

Finally, it must be stressed that even failure to satisfy the per se standard will not necessarily preclude a plaintiff from prevailing on his Sherman Act tying claim. Under the broader rule-of-reason standard “[a] plaintiff can still prevail on the merits whenever he can prove, on the basis of a more thorough examination of the purposes and effects of the practices involved, that the

though the power exists only with respect to some of the buyers in the market.

. . . “Even absent a showing of market dominance, the crucial economic power may be inferred from the tying product's desirability to consumers or from uniqueness in its attributes.”


62. *Id.* at 1163. In addition, the court found that a valid defense, that of business necessity, was established by the defendants. Generally, the business necessity defense is justifiable when a new product is being introduced into a highly competitive market—and then only for a limited period of time. For a fuller discussion of this and other valid defenses to antitrust allegations, see Austin, *supra* note 49.
general purposes of the Sherman Act have been violated."

Thus, if a plaintiff can establish that the escrow tying arrangement was so anticompetitive as to constitute an unreasonable restraint of trade, his challenge may be successful.

B. Conspiracy to Restrain Trade—Conscious Parallelism Standards

Admittedly, establishing sufficient economic power to impose a tie-in arrangement might be the weakest link in the borrowers' antitrust arguments. The gap may be bridged, however, by establishing that the lenders engaged in consciously parallel behavior indicative of a conspiracy in restraint of trade, violating section 1 of the Sherman Act. Since conscious parallelism is usually discussed in a sales or price fixing context, it is a difficult concept to apply in the escrow situation. It appears to be an ill-defined conspiracy concept requiring less than express agreement but more than independent identical actions. As one commentator noted:

[C]onscious parallelism is never meaningful by itself, but always assumes whatever significance it might have from additional facts. Thus, conscious parallelism is not even evidence of agreement unless there are some other facts indicating that the decisions of the alleged conspirators were interdependent, that the decisions were consistent with the individual self-interest of those concerned only if they all decided [sic] the same way.64

Another commentator has stated that conscious parallelism could be defined as a quasi-agreement: "'[W]hen a number of enterprises follow a parallel course of action in the knowledge and contemplation of the fact that all are acting alike, they have, in effect, formed an agreement.'"65

Establishing that lenders acted in a consciously parallel manner would require extensive discovery to determine the number of lenders using escrows, whether leading lenders converted to escrows first, and how quickly thereafter other lenders changed to escrows from capitalization. The large number of such changeovers in the late 1960's and early 1970's instigated the filing of the suits discussed above.66

Demonstrating that the self-interest of the lenders is advanced only if they act interdependently is not a difficult task. If all the major lenders in an area who have the economic ability to offer the most favorable mortgage terms to borrowers utilize the escrow method, then mortgagors have no real choice in

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66. See pp. 107-08 supra.
obtaining a favorable loan. Borrowers looking for the best mortgage terms must also accept the escrow conditions. As a result, all these lenders gain the use of the escrow funds and any profits derived therefrom. Yet if some major lenders refused to follow suit by not using the escrow tie-in, the borrowers would be likely to patronize these nonescrow lenders to obtain a loan on terms as favorable as those offered by the escrow lenders. The borrowers would gain the benefit of any alternative system the nonescrow lenders use, whether capitalization, an interest paying account, or the option of retaining the tax and insurance money. Thus, the effect of nonconformity among lenders would be to force open competition which might deprive lenders of the profits they now gain by use of the escrow method. Consequently, as long as the lenders who attract an appreciable number of borrowers act in this consciously parallel manner, they continue to benefit.

Statistics compiled by the mortgage industry67 may well support the existence of conscious parallelism. The United States Savings and Loan League, which represents a significant number of savings and loan associations, has issued a survey showing that 83.6 percent of such institutions used the escrow method and that those same lenders represented 92.0 percent of the total assets of those responding to the inquiry.68 The capitalization method was employed by only 16.4 percent of the respondents, representing 8 percent of the total assets of the same responding group.69 Since the survey was weighted toward the views of the larger savings and loan associations,70 it indicates that most of the larger institutions which control the greatest number of borrowers in the mortgage market use the escrow method. Significant questions remain, however, regarding when this method was adopted and whether smaller institutions knowingly switched to the escrow device with the intent of imitating the larger lenders.71

II. STATE COURT LITIGATION BASED ON BREACH OF FIDUCIARY DUTY CLAIM

The theory underlying a plaintiff's claim to interest and/or profits derived from the use of the collected funds is a simple one: the payments are the

67. United States Sav. & Loan League, Factors Governing the Economics of Escrow Accounts (Jan. 1973), in FHLBB Comments Folder, supra note 4 [hereinafter cited as Escrow Study].

68. The survey states that 20.8 percent of the member institutions responded to the questionnaire. These institutions represented 40.8 percent of the total national savings and loan assets. Escrow Study 2. Thus, this report reflects the practice of the larger and, logically, the more influential savings and loan associations.

69. Escrow Study 3.

70. Id. 2. See note 68 supra.

71. These inquiries might supply the evidence necessary to successfully assert the charge of conscious parallelism. See pp. 106-07 supra.
property of the mortgagors, to be used by the mortgagee exclusively for a specific purpose. By using the money for its own benefit, the lender breaches the fiduciary duty accompanying the special deposit or trust account. Thus, either interest should be paid to the mortgagor for the use of his money or, alternatively, there should be an equitable accounting of, and constructive trust placed on, the profits generated. State courts have differed in their responses to this rationale.\textsuperscript{72}

In the earliest of the fiduciary duty cases, *Sears v. First Federal Savings & Loan Association*,\textsuperscript{73} the court interpreted the mortgage contract language to determine the intent of the parties. The contract permitted three optional methods for the bank holding tax, insurance, and other assessed monthly payments: a trust account without interest, "carrying" the payments in an account, and capitalization. The bank opted for the second method and maintained an account on the ledgers, but commingled the funds. In the absence of an explicit duty to segregate the funds, and because the only contract obligation was to pay the bills when due, the court found no intent to create a trust or special deposit (nor was there found a res), as required for an actual trust. Consequently, the court concluded, there could be no breach of fiduciary duty as long as the parties' contract did not specify a trust obligation.

Subsequent cases have followed the *Sears* reasoning. In *Zelickman v. Bell Federal Savings & Loan Association*,\textsuperscript{74} the Illinois Court of Appeals decided that the term "deposit" in the mortgage contract, absent an explicitly defined duty to segregate, could not be construed as creating a trust account.\textsuperscript{75} The court stated that the fund in question was held only as additional security for the payment of bills. And in *Durkee v. Franklin Savings Association*,\textsuperscript{76} decided by the same court, the contract language spe-

\textsuperscript{72} See generally Annot., 50 A.L.R.3d 697 (1973).

\textsuperscript{73} 1 Ill. App. 3d 621, 275 N.E.2d 300 (1971).

\textsuperscript{74} 13 Ill. App. 3d 578, 301 N.E.2d 47 (1973). Plaintiffs sought an accounting on behalf of a class of mortgagors to impose a constructive trust on all earnings derived from lenders' use of the escrow funds. The court dismissed the complaint for failure to state a cause of action.

\textsuperscript{75} The court distinguished this case from *Carpenter v. Suffolk Franklin Sav. Bank*, 291 N.E.2d 609 (Mass. 1973) (holding that the complaint alleging the bank breached its fiduciary duty by commingling and deriving benefits from the escrows stated a cause of action), because in *Carpenter* the word "escrow" was relied upon to find a breach of fiduciary duty. 13 Ill. App. at 586, 301 N.E.2d at 53. It should be noted that the FHLBB regulations authorizing these deposits call the accounts "escrows." See notes 133-35 and accompanying text infra.

\textsuperscript{76} 17 Ill. App. 3d 978, 309 N.E.2d 118 (1974). The plaintiffs' claim for all profits derived from defendants' use of the deposits was dismissed for failure to state a cause of action.
cifically permitted the bank to commingle monthly payments instead of directing the bank to place the funds in a savings account. Since there existed no agreement requiring segregation or remuneration to the depositor for use of the funds, the court found that they could not be deemed a special deposit or bailment. Rather, the bank was permitted to use the funds for its own benefit.  

Countering the Illinois cases is Tierney v. Whitestone Savings & Loan Association, in which a New York court stressed that the deposits were called “security” in the particular mortgage contract and credited in an “escrow” ledger. Because the legal obligation accompanying an escrow is that of segregating the funds, and commingling defeats the purpose of keeping the funds secure for eventual payment of the mortgagor’s bills, the court concluded that the bank breached its fiduciary duty by its own use of the funds.

Determining the intent of the parties in an escrow situation is more difficult in the absence of an express contract provision. Mortgage contracts or promissory notes usually are silent concerning the particular manner in which deposits are to be held. The general rule is that when there is no express agreement as to an alleged trust, the circumstances surrounding the transaction must be examined to determine whether a trust or debt is created. In order to examine adequately these circumstances, general principles of banking law must be considered.

Deposits are made into one of three types of bank accounts: general, special, or special for a specific purpose. A general account creates a

77. The court found the Sears and Zelickman holdings not to be determinative because they were “expressly premised on the true meaning of the language contained in the specific mortgage agreements in each case.” Id. at 980, 309 N.E.2d at 119. In Durkee, the court also looked to the mortgage agreement and found that under the agreement the payments did not constitute special deposits or trust funds and that, therefore, defendant was not obligated to keep this money intact, separated, or segregated from other funds. Id. at 983, 309 N.E.2d at 121.

78. 77 Misc. 2d 284, 353 N.Y.S.2d 104 (Queens County Sm. Cl. 1974).

79. See RESTATEMENT (SECOND) OF TRUSTS § 32 comment 1, § 179 (1959). Often, “escrow” describes the delivery of an instrument to a third party, the escrow agent, until a stated condition for transfer occurs. But the term is not restricted to use with instruments. The delivery into escrow creates a trust which carries the legal obligation to segregate and hold the funds until the condition occurs. Id. In the tax and insurance escrow, the condition that occurs is the arrival of the date when the bills are due. At that time, the escrow holder (lender) must pay the bills.

80. 77 Misc. 2d at 288, 353 N.Y.S.2d at 109-10. The court discussed the historical purpose of these deposits and the meaning of “security.” Id. See generally TEMPLE L.Q. Comment, supra note 4, at 352.

81. 1 A. Scott, LAW OF TRUSTS § 12.2, at 112 (3d ed. 1967).

82. An account is presumed to be general unless it can be proven to be special. See 5A 4 MICHIE ON BANKS AND BANKING, ch. 9, § 3 (Michie Pub. Co. ed. 1973).
debtor-creditor relationship between the bank and customer and therefore no fiduciary duty; a special account creates a bailment or trust relationship with a resultant fiduciary duty requiring the bailee to segregate the entrusted property or money and hold it until the bailor gives instructions for its disposition; a special deposit for a specific purpose obligates the holder to complete that purpose but does not permit the holder to use the deposit for his own benefit. Thus, while the special deposit imposes a trust and the general deposit does not, the special deposit for a specific purpose has both a debt and trust character.

Many state courts, in considering breach of fiduciary duty allegations, have weighed the circumstances surrounding the transactions at issue in the context of motions to dismiss or for summary judgment, but few have reached a decision on the merits. In the leading case of Carpenter v. Suffolk Franklin Savings Bank, a Massachusetts court deemed the allegations sufficient to state a cause of action for breach of fiduciary duty, reasoning that federal regulatory authorization to collect and state statutory permission to invest these funds did not preclude finding a trust relationship between the parties and an obligation to pay profits and interest to the mortgagor. Since the monthly payments were designated for real estate taxes, a specific purpose seemed to exist which might render the bank a holder of an escrow. The court concluded that if, at trial, the contract language, conduct of the parties, and end to be accomplished further supported the existence of a trust, then a breach of fiduciary duty would be found in the lender's use of the funds for its own benefit.

In Buchanan v. Brentwood Federal Savings & Loan Association, the cause of action was remanded after analysis of the facts to determine if a trust had been established. The Pennsylvania court indicated that Massachusetts' Carpenter standard should be applied at trial when "the mortgagor pays funds to a bank with an expressed purpose that the funds shall be used for a particular purpose, [and] then the funds may be deemed to be held in trust." Additionally, the Buchanan court evaluated the argument that a constructive trust should be imposed on the defendants which would require the payment of the profits derived from the mortgagees' investments of the deposits to the mortgagors. This issue was remanded as well, to the court of equity, with the applicable standard that a constructive trust "arises" where

a person who holds title to property is subject to an equitable duty to convey it to another on the ground that he would be unjustly enriched if he were permitted to retain it. That the court undertook this substantive examination of the remedy when reviewing a motion to dismiss is possibly a preliminary indication of its willingness to find a breach of fiduciary duty on the facts of the case.

Courts in California and New York have upheld the breach of fiduciary duty concept. A New York court upheld the theory of the claim, but dismissed the case due to a deficiency in the pleading, while another New York court dismissed a similar claim after discovering the same technicality and additional substantive reasons why the escrow practice did not constitute a trust.

Since the cases have been inconclusive on the merits of the trust argument, an independent analysis is necessary to decide whether these deposits, absent an express agreement that manifests intent, constitute trusts or special deposits. Such an analysis requires, initially, an examination of the circumstances surrounding escrow transactions.

A. Circumstances Surrounding Escrow Transactions

Although some federal regulations authorize the collection of monthly escrow payments, the mortgagor is still primarily responsible for the payment of bills. Certainly, the lender who collects monthly payments for taxes and insurance assumes an obligation to pay the bills when due; otherwise he would be unjustly enriched. At issue is whether this obligation is based on a contract theory or a theory of fiduciary duty accompanying the deposits.

87. Id. at 126.
88. Abrams v. Crocker-Citizens Nat'l Bank, 41 Cal. App. 3d 55, 114 Cal. Rptr. 913 (Cal. App. 1974) (if trust argument proven, then plaintiffs may be entitled to equitable accounting for any gain from the use of the funds); Raab v. Bowery Sav. Bank, 77 Misc. 2d 1054, 355 N.Y.S.2d 748 (N.Y. County Sm. Cl. 1974). The Raab court expressly disagreed with the Tierney contract rationale. See p. 117 supra. Instead, the Raab court decided that the escrow was a deposit for a specific purpose and ruled that the defendant was not to commingle the funds or use them for its own benefit. Here, the plaintiffs were held entitled to an equitable accounting for defendant's gains through use of these deposits. 355 N.Y.S.2d at 751.
89. Id. at 751. The Small Claims Court does not have equitable jurisdiction. Since this was deemed an equitable cause of action, the case was dismissed.
90. Menkis v. Whitestone Sav. & Loan Ass'n, 356 N.Y.S.2d 485 (Nassau County Sm. Cl. 1974). The court found that deposits pursuant to the mortgagor-mortgagee relationship did not meet the trust requirement of a res, independent escrowee, conditional delivery to the escrowee, and depositor's relinquishment of all rights in the funds.
91. See, e.g., 12 C.F.R. § 545.6-11 (1975).
Several factors support the argument that the obligation is solely a matter of contract between the parties: the arrangement is ancillary to a mortgage contract and serves as additional security for the loan; the borrower remains primarily liable for the bills; there is a legal presumption that deposits are general unless there is express intent to create a trust; no trust res is segregated and maintained by the lender, and there is no agreement that the identical money deposited be used to pay the bills. Indeed, some statistics indicate that each account generates only 10 dollars profit per year, a figure which, if accepted as accurate, would not seem to justify imposing a trust.

Yet countervailing factors support the contrary conclusion that the deposits are held in trust. The payments are made so that a lender can pay bills when due and there is no evidence of intent to give the lender free use of the funds for its own benefit and profit, as would be implied by a general deposit. Since interest bearing accounts ordinarily signify general deposits, it may be argued conversely that noninterest accounts for a specific purpose indicate an intent to form a trust and to segregate the funds. In addition, it is unlikely that borrowers would knowingly deposit money into a noninterest account expecting lenders to use it in the same way that interest bearing accounts are used. Unlike a normal deposit, the escrow depositor has no right to withdraw its money, the result being a separation of legal and equitable ownership, as in any trust.

92. See Yudkin v. Avery Fed. Sav. & Loan Ass'n, 507 S.W.2d 689, 690 (Ky. 1974). Plaintiffs filed suit to compel the lender to pay interest on the escrow accounts. The court held that because the mortgage contract was silent on the payment of interest but included a provision binding borrowers to the resolutions of the lender, and a long standing resolution was not to pay "dividends" on the escrows, there could be no implied contract for the payment of such interest.

93. See notes 82-83 supra.

94. See Note, supra note 4, at 516. The estimate of profits is criticized because it presumes an annual average account of $400 at 5 percent interest, whereas the average account and short term loan interest rate are actually higher. Id. at 533-34. The author estimates that the actual industry-wide profits may total hundreds of millions of dollars per year. See note 4 supra.

95. See Note, supra note 4, at 524.


97. Borrowers would not knowingly deposit money into these accounts unless they needed the particular mortgage loan, or its terms were unique, in which case the borrowers would deposit money knowingly into a noninterest account, but not voluntarily. See generally 15 A. MICHE, BANKS AND BANKING, ch. 9, § 3 (1973). But see 1 G. BOGERT & G. BOGERT, TRUSTS AND TRUSTEES § 21, at 173 (2d ed. 1965), in which the authors argue that a depositor does not expect the identical money to be used to pay a debt to a third party and that therefore the arrangement should be deemed a contract rather than a bailment.
B. Importance of the Regulatory Terminology

The language contained in the regulatory authorization for payments should be examined closely.\(^8\) The FHLBB recently amended its regulation, and the amendment refers to the payments as "escrow accounts."\(^9\) The FHA regulation mandates that these payments be collected and held "for the benefit and account of the mortgagor."\(^1\) But the VA regulation, which mandates the collection of these monthly payments, states that they must be placed in a "reserve account."\(^1\) While the accounts are ambiguously named in the VA regulations, their characterization in the FHLBB and FHA regulations indicates that the funds are not to be commingled, and that any profits derived from the funds belong to the escrow for the benefit and account of the borrower.

Other FHA regulations covering approval of lending institutions specifically require that nonsupervised mortgagees maintain the mortgagor's monthly payments in a special account and order that the funds shall not be used for any other purpose than that for which they were received.\(^2\) In the section explaining that the failure to segregate, or use for an unintended purpose, shall result in withdrawal of approval as a mortgagee, the regulations refer to the deposits as an "escrow fund."\(^3\) Certainly FHA mortgagees must maintain accounts meeting all the technical legal requirements of escrows. If the accounts are invested by the mortgagee for its own benefit, there exists a breach of fiduciary duty. A possible remedy for the mortgagor is to trace the profits through an equitable accounting.\(^4\) Since the identical purpose of the accounts held by both FHA and non-FHA mortgagees is to additionally secure the loan, there is no reason to characterize the deposits as something other than true escrow accounts, as intended by the FHA. Had the authors of the regulations intended a different interpretation, they would not have termed the deposits "escrows."

C. General Banking Law Analysis

The conclusion that tax and insurance accounts should be considered true escrows is further supported by an examination of the banking cases

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98. Close examination is especially necessary since the courts in cases such as Sears, Zelickman, Tierney and Carpenter have placed great importance on the contract language used in each case.
100. 12 C.F.R. § 203.23 (1975).
103. Id. § 203.7.
involving special deposits. The issue of which type of account—general, special, or special account for a specific purpose—is created by deposits usually arises when a bank becomes insolvent. In order to gain preference when a trustee distributes the bank's assets, a depositor must prove that his deposit was held in trust or as a special account. The issues raised in the cases are similar to those involved in the disputes over the monthly tax and insurance payments.

Early cases found that when a bank became insolvent, "the circumstances of the deposit may give rise to an agency relation, a contract for the benefit of a third person, or, infrequently, a trust. . . . The difficulty encountered is the lack of a definite trust res." Even then, however, if the case involved fraud on the part of the bank when a trust was intended, the courts would permit tracing into the general bank funds, allowing the proper sum, if ascertainable, to constitute the trust res. Thus, there is precedent for imposing a trust on general bank funds even though the money deposited was commingled, as long as the amount that would have been the res is calculable.

In the seminal case of In re Interborough Consolidated Corp., the concept of a special deposit for a specific purpose was developed. Money was deposited to 'be paid to Interborough for a debt of the depositor. The court noted that this was an "ABC case" — one in which A places money in the hands of B to be delivered to C, and for no other purpose. This transaction was deemed to have created a trust and a fiduciary relationship arising therefrom. Similarly, deposits for tax, insurance, and assessments fit the ABC framework and may create a fiduciary duty to use the funds for no other purpose than that intended.

In the 1930's, when many banks failed due to insolvency, the question of whether an account was special or general was frequently litigated. For

106. See, e.g., Hitt Fireworks Co. v. Scandinavian Am. Bank, 121 Wash. 261, 209 P. 680 (1922) (when money earned was given to bank cashier with informal understanding that it be held by the bank as a special deposit, but the cashier deposited it as a general deposit, tracing was permitted); Carlson v. Kies, 75 Wash. 171, 134 P. 808 (1913) (when estate administrator placed monies in bank pending response from heirs, and bank wrongfully commingled this money with its general funds, tracing was allowed). Tracing is the equitable procedure of following earmarked cash when it is commingled or transformed into proceeds. See Note, 32 YALE L.J. 410 (1922).
107. 288 F. 334 (2d Cir. 1923).
108. Id. at 347. See Guidise v. Island Ref. Corp., 291 F. 922 (S.D.N.Y. 1923) (Learned Hand, J., upheld the ABC theory); Note, supra note 4, at 521, for a fuller discussion of the ABC case theory.
example, in the principal case of *Andrew v. Union Savings Bank & Trust Co.*, a creditor attached the bank account of his debtor and the bank subsequently went into receivership. The creditor argued that this attachment, filed prior to insolvency, transformed the general account into a special one and entitled him, not the bank's general creditors, to the assets in the account. In rejecting this contention, the court stated:

A different rule applies where money is merely left with the bank under an arrangement with the bank that the money is to be used by the bank for some special purpose as, for example, to turn over to a particular person or to pay a particular debt. In all such cases the money does not become the property of the bank. The fund is merely intrusted [sic] to the bank as a trustee or bailee without any authority on the part of the bank to use it as its own. The circumstances governed by this rule are identical to those in the tax and insurance deposit situation: both involve an arrangement to pay a third party for a debt incurred by the depositor.

Courts have differed over the issue presented in *Andrew* of whether bank accounts are special so as to justify a preference after a bank's failure. Generally, a third party creditor is permitted to enforce a trust more often than a depositor who tries to have his deposit returned. Since the ABC nature of the transactions is the same, there is no reason to distinguish the characterization of the deposits for tax and insurance from these banking cases.

Another type of case lends considerable support to the conclusion that the tax and insurance accounts are escrows or special deposits. In *Liberty National Life Insurance Co. v. United States*, the plaintiff insurance company was a mortgage lender using the escrow method and commingling the deposits with other funds. At issue in the case was whether these escrow funds, which formed a larger sum than Liberty's insurance-related funds, constituted "assets" for the purpose of calculating federal income tax. The court found that they were trust funds which could not be disbursed for any purpose other than to pay bills, and commingling did not destroy their

110. Id. at 715, 263 N.W. at 497. See also State v. Platte Valley State Bank of Scottsbluff, 130 Neb. 222, 264 N.W. 421 (1936) (a simple designation that the deposit was held pending the outcome of a suit was sufficient to create a special deposit for a specific purpose); Annot., 50 A.L.R.3d 697 (1973) (rights in funds representing "escrow" payments made by mortgagor in advance to cover taxes or insurance).
112. 463 F.2d 1027 (5th Cir. 1972). The insurance company was seeking a tax refund.
Liberty was prohibited from investing the funds in the future or retaining any income from funds already invested. In a footnote, the court explained that paying over the interest derived is based on a general principle of law. Although the court failed to define the principle, it is apparent that unjust enrichment due to breach of fiduciary duty was the one intended. The court continued by quoting a dictate of the Department of Housing and Urban Development concerning FHA loans:

[W]henever a mortgagee invests escrow funds in interest-bearing accounts the interest must accrue to the benefit of the mortgagor rather than to the benefit of the mortgagee. It is FHA’s position that a mortgagee who deposited escrow funds in an account bearing interest for the benefit of the mortgagee would be in violation of FHA regulations.

Since there is no basis for distinguishing between the security purposes of FHA and non-FHA loans, these standards should be applied generally. Nor is it sensible to distinguish between insurance companies and other institutions when they function as mortgagees, because they are engaged in the same profitmaking business of lending to real property purchasers. Using analogous reasoning, then, profits derived from any mortgagee’s investment of the funds should go to the mortgagors.

III. LEGISLATIVE AND ADMINISTRATIVE SOLUTIONS

Viewed in their entirety, the relevant regulatory language, the nature and purpose of the tax and insurance deposits, the banking cases, and the tax case are persuasive evidence that the escrow account should be viewed as a trust. Recently, legislatures and agencies have reacted to this situation with compromise remedies tending to favor the borrowers.

Consumer borrower-oriented state legislation is the primary source of reform. Most of the new statutes require that the lender pay interest on the accumulation of the mortgagor’s monthly payments. Interestingly, the FHLBB has issued new regulations restricting the effect of the statutes to certain limited circumstances. No statute or regulation has ordered mortgagees to pay profits to the borrowers.

One of the earlier statutes was that of New Hampshire, which requires all lenders to pay interest on escrow accounts maintained for the payment of taxes and insurance.

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113. Id. at 1029. See notes 79, 82-83 & accompanying text supra for discussion of the duty of a trustee not to commingle trust and general funds.
114. Id. at 1030.
115. Id. n.6.
116. Id.
117. See note 135 & accompanying text infra.
taxes, insurance premiums, and other assessments. The rate is set at "not less than two percent below the rate paid on regular savings deposits in said bank." New Mexico's statute does not require payment of interest but merely discourages accumulation of excessive escrow deposits. Upon a mortgagor's demand, a lender holding an escrow account must credit any money deposited in excess over the annual taxes, insurance premiums and assessments towards the principal amount of the mortgage. Alternatively, the parties can contract for another disposition of the excess. A penalty for noncompliance is set at six percent annual interest on the excess amount. In Arizona, a somewhat different statute requires that all money deposited in escrow be kept separate from other funds. Interest received on the escrow must be paid to the depositor and shall not become part of the escrow agent's funds. But the section expressly states that this requirement shall not restrain the parties from contracting as to the disposition of the interest. The statute is ambiguous in that "interest" is not defined as either a rate comparable to that earned on general deposits or the amount of profit generated by the mortgagors' investment of the funds.

More recent statutes mandate the payment of interest but limit the effect to a smaller class of mortgages. In Connecticut, a minimum of two percent interest is to be paid to mortgagors of owner-occupied residential property consisting of not more than four living units. In Massachusetts, the law requires that interest be paid (at a rate determined by the mortgagee) only by the first mortgagee on dwellings that include no more than four separate households, or are owner-occupied.

New York's recently enacted statute is complex, requiring that interest be paid pursuant to state banking board regulations for a one to six family residence that is owner-occupied. This provision is subject to several exceptions: no interest shall be paid when there is a prior express contract disclaiming this responsibility, when a federal law or regulation would be violated, or when a prior contract exists with a nonlending institution to hold the escrow. The interest is established at an annual rate of not less than two percent, calculated on the average of the sums in the account for an average length of time, or as established by the banking board.

119. Id.
121. ARIZ. REV. STAT. ANN. § 6-834 (1974).
122. CONN. GEN. STAT. ANN. § 49-2a (Supp. 1975).
123. MASS. GEN. LAWS ch. 183, § 61 (Supp. 1975).
Although some of these statutes indicate an intent to defer to a contract between the parties, they consistently recognize the continuing stake of the mortgagor in the deposits. It is significant that many of the statutes call the accounts "escrows."\textsuperscript{126} Presumably, legislators intend the legal consequences which flow from their choice of words. If these accounts are actually escrows, then mortgagors are not precluded from pursuing a cause of action for profits generated due to the lender's breach of fiduciary duty in using the fund for its own benefit.

In contrast to this trend, Louisiana's recently enacted statute does not use the term "escrow" or require the payment of interest. Instead, the statute mandates that the monthly deposits "be held, without interest, for the credit of the borrower."\textsuperscript{127} Thus, it could be interpreted as creating a noninterest special deposit for a specific purpose and a trust for the benefit of the mortgagors. If the lender commingles and invests the funds, the borrower may have both common law and statutorily based claims for breach of fiduciary duty.

New York's statute has been attacked as unconstitutional in \textit{Jamaica Savings Bank v. Lefkowitz}\textsuperscript{128} and \textit{Federal National Mortgage Association v. Lefkowitz}\.\textsuperscript{129} Jamaica Savings argued that a mortgage contract entered into prior to enactment of the relevant legislation was impaired because the noninterest account was essentially a bargained-for term. The court found no evidence to prove that bargaining took place, and held that in the absence of a contract provision for the use and disposition of income derived from escrow accounts, it could not be established that nonpayment of interest was a contract term.\textsuperscript{130} A second contention, that the statute effected a taking without due process, was rejected after the court decided that the bank never had a beneficial interest in the funds, since the escrow accounts were never intended to be used by the mortgage institution for its own benefit.\textsuperscript{131} In

\textsuperscript{126} See, e.g., 4 N.H. REV. STAT. ANN. § 384:16-C (Supp. 1973), which provides:

Any bank which requires or accepts money for deposit in escrow accounts maintained for the payment of taxes, insurance premiums or other expenses related to loans on property secured by real estate mortgages shall credit each such escrow account with interest at a rate not less than two percent below the rate paid on regular savings deposits in said bank.

\textsuperscript{127} LA. REV. STAT. § 6:828 (Supp. 1975).

\textsuperscript{128} 390 F. Supp. 1357 (E.D.N.Y. 1975).

\textsuperscript{129} 390 F. Supp. 1364 (S.D.N.Y. 1975).

\textsuperscript{130} Id. at 1360-62. The bargaining issue may develop, eventually, into an unconscionability argument. See \textsc{Temple L.Q. Comment}, \textit{supra} note 4, at 360.

\textsuperscript{131} 390 F. Supp. at 1367.
Federal National Mortgage Association, the court followed the reasoning of Jamaica Savings and reached the same conclusions. In addition, it contended that a state statute can subject a federal instrumentality to state law under certain circumstances. Thus, these cases, which establish the state's power to mandate the payment of interest on escrow accounts, further support the argument that these funds are true escrow accounts or special deposits.

The FHLBB has also responded to the controversy surrounding these deposits. On October 24, 1974, in an attempt to preempt state authority, the agency proposed an amendment to the existing regulation. Three months later, the FHLBB modified its position and proposed a revised, more complex amendment. After receiving comments on the proposal and making a few changes, the FHLBB issued the final version, effective June 16, 1975, which operates prospectively to avoid impairment of existing

132. Id. at 1368. The issue of whether the FHLBB regulations preempt any state laws was not justiciable in this case. However, this is an issue likely to be raised in future litigation.

133. 39 Fed. Reg. 41386 (1974). The proposed amendment states in relevant part: The payment of interest on the amount of advance payments of charges as described in the preceding sentence [for taxes, insurance premiums and other assessments] is solely a matter of contract between a Federal association and borrowers therefrom, without regard to any provision of State law relating to payment of interest.

134. 40 Fed. Reg. 4661 (1975). Interest would be paid on “escrow accounts”: (1) Only if contracted for by Federal association and borrower, except if the loan: (a) is made on a single-family dwelling to be occupied by borrower, (b) the dwelling is located in a State where State chartered thrift institutions generally are so required, and (c) the loan is made on or after the effective date of the regulation . . . . (2) If interest payment required, payment shall be at not less than State rate but not in excess of passbook rate.

135. FHLBB, Amendment Relating to Escrow Funds, No. 75-415 (May 9, 1975). 12 C.F.R. § 545.6-11 will include this provision:

(c) Payment of interest on escrow accounts. A Federal association which makes a loan on or after June 16, 1975 on the security of a single-family dwelling occupied or to be occupied by the borrower (except such a loan for which a bona fide commitment was made before that date) shall pay interest on any escrow account maintained in connection with such a loan (1) if there is in effect a specific statutory provision or provisions of the State in which such dwelling is located by or under which State-chartered savings and loan associations, mutual savings banks and similar institutions are generally required to pay interest on such escrow accounts, and (2) at not less than the rate required to be paid by such State-chartered institutions but not to exceed the rate being paid by the Federal association on its regular accounts . . . . Except as provided by contract, a Federal association shall have no obligation to pay interest on escrow accounts apart from the duties imposed by this paragraph.
contracts. It is a restrictive provision, extending no further than to give effect to state statutes mandating the payment of interest. The regulation restricts the rate to a sum not greater than that paid by federal associations on regular accounts, regardless of the state's set rate. This regulation, however, raises still another question: whether a state statute or the FHLBB has controlling authority to set the interest rate. Undoubtedly, this issue will soon be litigated.

Most noteworthy in the FHLBB amendment is the characterization of these deposits as "escrow accounts." Again, given a legislative intent to construe the term in its strict legal sense, mortgagors would seem to have federal authority for the fiduciary duty argument. Clearly, the right to trace profits derived is a more lucrative endeavor than receiving statutory interest on the deposits.

IV. CONCLUSION

Lending institutions are caught in the middle of the FHLBB, protective courts, progressive courts, state legislators, and consumer advocates. The mandate that they pay interest forces lenders to use the funds for their own benefit to offset interest payments. It is this use that breaches the fiduciary duty of the "special account for a specific purpose" and permits the mortgagor to trace and demand the profits derived from the funds. Lending institutions have available the options of absorbing the cost of paying interest, continuing to invest the funds, or returning to the capitalization method. Capitalization, the institutions contend, is not as profitable as the escrow method, and originally the switchover to escrows was an attempt to increase profits. But it seems inconceivable that the administrative costs of capitalization exceed costs of maintaining escrow accounts. Lending institu-

136. The rationale underlying the FHLBB's restrictive approach, which works to the detriment of borrowers, appears to be that each individual mortgagor would gain only a minimal amount if the mortgagee were required to distribute profits derived. However, this assumption by the FHLBB is based upon the low estimates of profits resulting from the use of the accounts propounded by the lending institutions themselves. The FHLBB comment folder includes numerous responses from mortgagees indicating that the profits derived from the escrow deposits defray administrative costs otherwise chargeable to the mortgagor. Even when the estimates concede that a profit is derived, the amount stated is usually a mere 10 or 20 dollars. Since the FHLBB represents banking interests, its reliance on the mortgagees' estimates is not surprising, nor is its restrictive regulation. See FHLBB Comments Folder, supra note 4.


138. See FHLBB Comments Folder, supra note 4.
tions continuing the escrow practice of commingling and investing the funds risk a law suit and possible judgment requiring that all profits derived be turned over to the borrowers. Unless the lenders are deriving enormous profits through these investments, the risk of loss through a judgment ought to justify abolition of the escrow practice. Besides being a prudent course for the careful lender, doing away with the escrow practice would be applauded by consumer advocates as a good faith effort to end deceptive mortgage lending practices. A prudent lender might be rewarded with an influx of reliable borrowers searching for the fairest terms, thereby increasing the profits from its mortgage lending.

Since the escrow practice is still predominant among lending institutions,138 greater mortgagor protection concerning these monthly payments is required. The next step must be in one of two directions: either a concerted lobbying effort to influence the FHLBB, other agencies, and state legislatures to broaden the payment of interest provisions, or the pursuit of lawsuits for breach of fiduciary duty, as outlined above. Lobbying is an expensive and long-range undertaking which may result in a uniform national statute mandating the payment of interest, but it is unlikely from a practical standpoint that statutes will order the payment of profits derived from use of the escrow funds, as the legislation discussed above indicates. On the other hand, law suits are comparatively less expensive to pursue. While the litigious approach has the disadvantage of touching only a limited community of defendants, it may result in an equitable accounting for profits earned or treble damages for an antitrust violation. Aside from its financial advantages, it is probably a swifter course than lobbying for years to achieve passage of a compromise statute. In addition, if a sufficient number of courts find violations in the escrow practice, more effective administrative and legislative action may be elicited. Consequently, the lawsuit, at least in the short run, seems the more fruitful course of action and one that seems likely to be pursued while the interest of the courts, legislatures, and administrative bodies is at its present height.

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139. Id.