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## Allocating the Risks of Embezzlement by an Escrow Holder: *Bio-Electronics v. C & J Partnership*, 268 Neb. 252, 682 N.W.2d 248 (2004)

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Note\*

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## I. INTRODUCTION

In real estate transactions, escrows are often used to help facilitate the deal and provide piece of mind to the parties involved. In the typical escrow arrangement, the seller agrees to place the deed and other documents related to title of the property with a disinterested third party who serves as the escrow holder or agent.<sup>1</sup> The buyer similarly

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1. Charles H. Walker & William D. Eshee, Jr., *The Safeguards and Dilemmas of Escrows*, 16 REAL EST. L.J. 45, 45 (1987).

deposits all or a portion of the purchase price with the escrow agent. These items are held in escrow until the conditions set out by the two parties in the escrow agreement are met.<sup>2</sup> Upon occurrence of the stated conditions, the escrow agent delivers the deeds or documents to the buyer and the money to the seller, thus completing the transaction.<sup>3</sup>

The use of an escrow is beneficial in these transactions because it protects both parties—neither is left vulnerable to fraudulent acts by the other. The escrow holder essentially acts as a safeguard during the transitional period when the ownership of the property is in limbo. Unfortunately, both parties are still exposed to the possibility of fraudulent or negligent behavior on the part of the escrow agent who is supposed to be protecting them. One potential problem of the escrow arrangement is that the escrow holder will take advantage of the position of trust in which he has been placed and embezzle the money under his custody.<sup>4</sup>

Determining which party should bear the loss when the funds are embezzled by the escrow holder is often a difficult and troublesome task. The one who is responsible for the hardship has typically either disappeared or become insolvent, so the two parties to the transaction are left to battle between themselves over the missing funds. An equitable remedy seems impossible in such a situation as both parties are generally innocent of any wrongdoing.<sup>5</sup> The inevitable result is that one blameless party will suffer a substantial loss while the other will still reap the benefits of the deal.<sup>6</sup>

This unfortunate situation is exactly where the parties in *Bio-Electronics v. C & J Partnership*<sup>7</sup> found themselves. In deciding this case, the Nebraska Supreme Court backed away from the previous escrow embezzlement jurisprudence where the purchaser alone had to bear the risk of loss. Instead, the court focused its analysis solely on a technicality of the Nebraska Uniform Commercial Code (“U.C.C.”), with

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2. *Id.*

3. *Id.* at 45–46.

4. See Robert L. Flores, *A Comparison of the Rules and Rationales for Allocating Risks Arising in Realty Sales Using Executory Sales Contracts and Escrows*, 59 Mo. L. Rev. 307, 307 (1994).

5. The decision becomes easier in cases where one of the parties to the transaction has some level of culpability for the loss (i.e., committing an act that is greater than mere delay), that allows the embezzlement to take place. See, e.g., *Majors v. Butler*, 221 P.2d 994 (Cal. Dist. Ct. App. 1950); *Jones v. Lally*, 511 So. 2d 1014 (Fla. Dist. Ct. App. 1987).

6. One trial court did attempt to split the loss between the buyer and seller, but that decision was overturned in favor of a rule allocating the loss to the legal owner of the embezzled funds. See *Cradock v. Cooper*, 123 So. 2d 256 (Fla. Dist. Ct. App. 1960).

7. 268 Neb. 252, 682 N.W.2d 248 (2004).

almost no reference to the way loss allocation has historically been applied.<sup>8</sup>

Part II of this Note explores the development of the rules behind allocation of risk in an escrow transaction, focusing in particular on two cases that had significant roles in establishing these rules. Next, the factual background of *Bio-Electronics* is discussed in detail in Part III. In Part IV, this Note discusses the implications of the court's holding in relation to the theories of ownership and agency in loss allocation, suggesting that this decision seems to put these two theories at odds in the rare situation like the one involved in *Bio-Electronics*. In addition, this Note addresses the underlying policy considerations that, although not discussed by the court, may have been at the heart of the holding. Finally, in Part V, this Note concludes that because of the unusual facts of this case and its somewhat anomalous result, the court's holding should and will be narrowly limited in its application to future cases.

## II. LEGAL BACKGROUND

### A. Development of the Entitlement Rule: Ownership and Agency

Every jurisdiction that has addressed the issue of escrow loss has turned to what has been referred to as the "entitlement rule" in deciding which party must bear the loss.<sup>9</sup> This rule has generally been credited to two separate but similar California cases: *Hildebrand v. Beck*<sup>10</sup> and *Shreeves v. Pearson*.<sup>11</sup> While both cases arose out of the misconduct of the same escrow agent, the California Supreme Court based its findings for these cases from two somewhat different theories of liability.<sup>12</sup>

In *Shreeves*, the first of the two cases, the seller and buyers entered into an agreement for the sale of real property. The transaction was to take place through an escrow, conditioned upon the seller's ability to deliver a valid deed to the property and to prove that she had an unencumbered title.<sup>13</sup> During the period before all the conditions were met, the parties agreed that the buyers would take immediate possession of the house prior to the close of the escrow, and in consideration, the seller would be paid a portion of the funds held in escrow.<sup>14</sup> The

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8. *Id.* at 257-58, 682 N.W.2d at 252-53.

9. Flores, *supra* note 4, at 309.

10. 236 P. 301 (Cal. 1925).

11. 230 P. 448 (Cal. 1924).

12. Flores, *supra* note 4, at 351-52; see also H.D. Warren, Annotation, *Who Must Bear Loss Resulting from Defaults or Peculations of Escrow Holder*, 15 A.L.R.2d 870 (1951).

13. *Shreeves*, 230 P. at 448.

14. *Id.* at 450.

seller was issued a check from the escrow company, which was returned unpaid, and the escrow agent subsequently disappeared with the funds.<sup>15</sup>

The seller prevailed in an action to regain possession of the premises. The court based its holding on the theory of agency, stating that the escrow holder is the agent of the buyer with respect to the money, and the agent of the seller with respect to the deed or other documents. The escrow holder's role does not change until each party has become completely entitled to the item that is to be transferred to him under the agreement.<sup>16</sup> Before all the conditions precedent to the exchange have been met with respect to the money in escrow, the escrow holder remains the agent of the buyer or the depositor.<sup>17</sup> In *Shreeves*, all the conditions of the escrow had not been met at the time of the embezzlement, and as a result, the buyers had to bear the loss caused by their agent.<sup>18</sup>

In *Hildebrand*, the court employed a different theory to reach the same conclusion that the buyer must bear the risk that his funds will be embezzled before the time to complete the transaction has arrived. The facts were substantially similar to those of the *Shreeves* case: the buyer of property deposited the purchase price in escrow, which was then embezzled before the title to the property could be guaranteed as required by the terms of the agreement.<sup>19</sup> This time, the California Supreme Court focused not on the relationship of the escrow agent to each party, but instead on the ownership of the funds.<sup>20</sup> The court determined that because the money was embezzled before all the conditions of the exchange had been satisfied, it remained under the ownership of the buyer and was therefore the buyer's money to lose.<sup>21</sup>

These two theories both lead to the rule that the "wrong of an escrow holder, must, as between the parties to the escrow transaction, be borne by the one who, at the time of its occurrence, was lawfully entitled to the right or property affected."<sup>22</sup> However, while both theories lead to the same conclusion, most jurisdictions seem to address the issue in terms of ownership, as in *Hildebrand*, instead of using the

15. *Id.*

16. *Id.* at 451.

17. *Id.*; see also, e.g., *Lieb v. Webster*, 190 P.2d 701 (Wash. 1948) (holding that where the condition that a title insurance policy be delivered to the buyer was not met, the escrow agent remained the agent of the buyer).

18. *Shreeves*, 230 P. at 453.

19. *Hildebrand v. Beck*, 236 P. 301, 303 (Cal. 1925).

20. See *Flores*, *supra* note 4, at 352.

21. *Id.*

22. *Warren*, *supra* note 12, at 87; see also *Flores*, *supra* note 4, at 352.

agency terminology of *Shreeves*.<sup>23</sup> Nebraska follows the general rule that "if an escrow agent 'embezzles the funds before the time has come to release them, he has embezzled the funds of the depositor.'"<sup>24</sup> This language is also more in line with the allocation of risk based on ownership; however, Nebraska has referred to the agency theory as well in escrow cases.<sup>25</sup>

## B. Equitable Considerations in Risk Allocation

One final consideration in allocating loss is the rule that "when one of two innocent parties must suffer, the one [who] made the occurrence of the event possible must suffer, rather than the one who is entirely without blame."<sup>26</sup> This general rule of law has been applied in escrow cases where the acts or omissions of one party allowed the escrow agent an opportunity to commit the fraud.<sup>27</sup> It can be used as an equitable "trump card" to hold one party liable for the embezzled funds, even if he was not the owner of the funds and the escrow holder was not acting as his agent. For example, in another case from California, *Majors v. Butler*,<sup>28</sup> the sellers failed to furnish documents sufficient to show good title as required by their escrow agreement. The court held that they acted negligently in not complying with the allotted time limit for producing the proper documentation, thus extending the period of risk accompanying the escrow.<sup>29</sup> Although ownership of the funds had not yet changed hands, the court reasoned that the sellers should be held responsible for the loss because they allowed it to occur, rather than imposing the loss on the blameless buyer.<sup>30</sup>

## III. FACTUAL BACKGROUND

The appellees in the present case, C & J Partnership, Krieger Family Children's Trust, Chuck Uribe, John Daubert, and Albert Pepler

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23. Flores, *supra* note 4, at 352; *see, e.g.*, *Bixby Ranch Co. v. United States*, 35 Fed. Cl. 674 (1996); *Cradock v. Cooper*, 123 So. 2d 256 (Fla. Dist. Ct. App. 1960); *Zarembo v. Konopka*, 228 A.2d 91 (N.J. Super. Ct. Ch. Div. 1967).

24. *Bio-Electronics v. C & J Partnership*, 268 Neb. 252, 257, 682 N.W.2d 248, 252 (2004); *see also* 28 AM. JUR. 2D *Escrow* § 31 (2000).

25. *See Rehmeier v. Lysinger*, 109 Neb. 805, 809-10, 192 N.W.2d 337, 338-39 (1923).

26. *Scottsbluff Nat'l Bank v. Blue J. Feeds, Inc.*, 156 Neb. 65, 83, 54 N.W.2d 392, 403 (1952); *see also VRT, Inc. v. Dutton-Lainson Co.*, 247 Neb. 845, 851, 530 N.W.2d 619, 623-24 (1995); *Rehmeier*, 109 Neb. at 811-12, 192 N.W. at 339-40.

27. *See, e.g.*, *Majors v. Butler*, 221 P.2d 994 (Cal. Dist. Ct. App. 1950); *Jones v. Lally*, 511 So. 2d 1014, 1016 (Fla. Dist. Ct. App. 1987) (finding that the sellers were the least innocent in a transaction for the sale of their house because they failed to properly endorse the buyer's check, giving the escrow agent an opportunity to stop payment on the check and abscond with the funds).

28. 221 P.2d 994 (Cal. Dist. Ct. App. 1950)

29. *Id.* at 997-98.

30. *Id.* at 998.

(collectively "C & J Partnership"), were the owners of the real estate in dispute.<sup>31</sup> For over fifteen years, they had leased the property to the appellant, Nebraska Hospital Association Charitable, Scientific, and Educational Foundation, doing business as Bio-Electronics ("Bio-Electronics").<sup>32</sup>

On November 9, 2001, Bio-Electronics offered to purchase the property that had been the subject of the lease.<sup>33</sup> Their offer of \$152,870 was accepted by C & J Partnership on November 13, 2001.<sup>34</sup> The closing was scheduled for December 20, 2001, at the offices of the designated title agent, State Title Services, Inc. ("State Title").<sup>35</sup>

The parties intended to close the sale by a simultaneous exchange of the deed for the purchase price.<sup>36</sup> At the closing, Bio-Electronics delivered a cashier's check for the full amount of the agreed purchase price, made payable to C & J Partnership.<sup>37</sup> The check was then endorsed on behalf of C & J Partnership by one of its partners, Chuck Uribe.<sup>38</sup> However, the exchange could not be completed at that time because another partner, Albert Pepler, had not yet signed the warranty deed.<sup>39</sup>

At this point, the details of what occurred at the closing become a bit fuzzy. Because the warranty deed was not fully executed, the exchange had to be delayed. The cashier's check was consequently placed in escrow with State Title pending completion of the warranty deed.<sup>40</sup> It is unclear whether the partially executed warranty deed was held in escrow as well, or if it was simply left at State Title's office.<sup>41</sup> There was also much dispute over whether it was Bio-Electronics or C & J Partnership who actually requested that the funds be placed in escrow. It was apparently Uribe's understanding that "he signed the back of the cashier's check on behalf of C & J Partnership in order to allow Bio-Electronics to deposit the proceeds in escrow with State Title."<sup>42</sup> Bio-Electronics, on the other hand, contended that "C

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31. *Bio-Electronics v. C & J Partnership*, 268 Neb. 252, 253, 682 N.W.2d 248, 250 (2004).

32. *Id.*

33. *Id.*

34. *Bio-Electronics v. C & J Partnership*, No. CI02-568, Order at 2 (Neb. Dist. Ct. Nov. 1, 2002).

35. *Bio-Electronics*, 268 Neb. at 253, 682 N.W.2d at 250.

36. *Id.* at 254-55, 682 N.W.2d at 251.

37. *Id.* at 253, 682 N.W.2d at 250.

38. *Id.* at 253-54, 682 N.W.2d at 250.

39. *Id.* at 254, 682 N.W.2d at 250.

40. *Id.* at 255, 682 N.W.2d at 251.

41. *Id.*

42. *Id.*

& J Partnership . . . indors[ed] the check and deposit[ed] it with State Title."<sup>43</sup>

After the scheduled closing, C & J Partnership and State Title were in contact in regards to obtaining the missing signature. On January 22, 2002, a copy of the warranty deed was sent to Pepler, who received it on January 23, 2002.<sup>44</sup> However, the same day the deed was sent, the president of State Title committed suicide amid allegations of embezzlement.<sup>45</sup> On January 28, 2002, before the warranty deed was signed and executed, State Title filed for bankruptcy under Chapter 7.<sup>46</sup> Among the funds that had been embezzled were the \$152,870 that had been intended for the purchase of property by Bio-Electronics.<sup>47</sup>

Bio-Electronics filed a petition for specific performance of the contract, contending that it had fully performed under the purchase agreement and requesting that C & J Partnership convey the warranty deed with clear title.<sup>48</sup> C & J Partnership moved for summary judgment, arguing conversely that Bio-Electronics had not performed under the agreement because the money was embezzled before it could be delivered.<sup>49</sup> The district court held that ownership of the funds had not passed from Bio-Electronics to C & J Partnership because the condition that would allow them to be released to the seller's control had not yet occurred.<sup>50</sup> The court also determined that State Title served as Bio-Electronics' agent to protect its funds.<sup>51</sup> The court did address the fact that were it not for C & J Partnership's failure to deliver a fully executed warranty deed, the embezzlement would not have occurred. However, it concluded that the delay was not unreasonable because time is not of the essence in the ordinary sale of real estate.<sup>52</sup> Based on these findings, the district court granted C & J Partnership's motion for summary judgment.

In reversing the district court's decision, the Nebraska Supreme Court relied on the Nebraska U.C.C. in its finding that ownership of the funds had indeed passed from Bio-Electronics to C & J Partnership.<sup>53</sup> The court looked to the provisions on the transfer and enforce-

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43. Brief of Appellant at 12, *Bio-Electronics*, 268 Neb. 252, 682 N.W.2d 248 (No. S-03-068) [hereinafter Appellant Brief].

44. *Bio-Electronics v. C & J Partnership*, No. CI02-568, Order at 7 (Neb. Dist. Ct. Nov. 1, 2002).

45. *Id.* at 2.

46. *Bio-Electronics*, 268 Neb. at 254, 682 N.W.2d at 250.

47. *Id.*

48. *Id.*, 682 N.W.2d at 251.

49. *Id.*

50. *Id.* at 255, 682 N.W.2d at 251.

51. *Id.*

52. *Bio-Electronics v. C & J Partnership*, No. CI02-568, Order at 8 (Neb. Dist. Ct. Nov. 1, 2002).

53. *Bio-Electronics*, 268 Neb. at 257, 682 N.W.2d at 253.

ment of negotiable instruments to determine that C & J Partnership became the holder in due course of the cashier's check when Uribe took possession of the check. This possession was further evidenced by Uribe's endorsement of the check.<sup>54</sup> The court unanimously determined that because C & J Partnership was technically the owner of the funds at the time they were embezzled, it should bear the loss, without any elaboration on the general rules of risk allocation.<sup>55</sup>

#### IV. ANALYSIS

The Nebraska Supreme Court's holding in *Bio-Electronics* is consistent with the theory that the owner or depositor of the funds held in escrow bears the risk of loss. However, the court relied heavily on the technical aspects of negotiable instruments without truly addressing some of C & J Partnership's arguments on the transfer of ownership through escrow. In addition, it is difficult to reconcile this decision with the theory that the escrow holder was acting as the agent of the depositor. In this case, it seems that the two theories behind the entitlement rule would have led to different results. This inconsistency indicates that perhaps there were more policy considerations behind this decision than the court revealed in its brief opinion.

##### A. Ownership Theory

*Bio-Electronics* demonstrates how critical timing is in determining when ownership of the items being exchanged has been transferred. C & J Partnership argued that the funds could not have been transferred until a fully-executed warranty deed was delivered as this was an essential condition of the sale.<sup>56</sup> This argument was evidently based on the typical escrow arrangement where the buyer places the money in escrow in order to protect it from being taken before the time when all the conditions of the closing can be met.<sup>57</sup> Under the normal circumstances stated above, C & J Partnership would have been correct in arguing that because all the conditions of the escrow had not been fulfilled, ownership of the funds had not been shifted. The facts of this case did not fit within the typical escrow arrangement, however. In this case, the result was based on the fact that ownership of the funds changed hands not *through* the escrow, but *before* it.<sup>58</sup>

The flaw in C & J Partnership's argument was that it failed to recognize that the conditions required under the escrow agreement were

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54. *Id.* at 257-58, 682 N.W.2d at 253; see NEB. REV. STAT. §§ 3-102 to -105, -201, -301 to -302 (Reissue 2001 & Cum. Supp. 2004 & Supp. 2005).

55. *Bio-Electronics*, 268 Neb. at 258, 682 N.W.2d at 253.

56. Brief of Appellee at 9, *Bio-Electronics*, 268 Neb. 252, 682 N.W.2d 248 (No. S-03-068) [hereinafter Appellee Brief].

57. See Walker & Eshee, *supra* note 1, at 45.

58. Appellant Brief, *supra* note 43, at 13.

separate from those required to transfer possession of the funds before the escrow agreement was formed. C & J Partnership approached the argument as if the condition that the warranty deed be delivered was applied directly to the cashier's check.<sup>59</sup> In reality, no condition was applied to the transfer of the cashier's check from Bio-Electronics to C & J Partnership; the court found that the simple act of delivering it was sufficient to transfer possession.<sup>60</sup> Delivery of the warranty deed was only necessary to release the funds *after* they had been placed in escrow by C & J Partnership.

The court used a straightforward application of the Nebraska U.C.C. in its determination that C & J Partnership was the legal owner of the funds before they were placed in escrow.<sup>61</sup> Because C & J Partnership was the owner of the money prior to the placement of the funds in escrow, it was also considered to be the depositor. As the legal owner and depositor of the embezzled funds, C & J Partnership was correctly made to bear the loss under the ownership theory. However, the court should have specifically addressed why C & J Partnership's argument was not effective, rather than relying solely on the provisions of the Nebraska U.C.C. Due to the fact that ownership was transferred before the escrow even existed, the conditions placed on the escrow arrangement became irrelevant.

## B. Agency Theory

The district court also addressed the issue of agency in its decision in favor of C & J Partnership, but the Nebraska Supreme Court made no mention of this theory in reversing the lower court.<sup>62</sup> One might wonder why the court would fail to even acknowledge one of the losing side's most arguable points. Perhaps the reason the court chose not to take up this issue is that it would most likely have led to the exact opposite conclusion that was reached by employing the ownership theory.

This case presented the unusual situation in which the seller was found to be the depositor of the funds.<sup>63</sup> However, this is contrary to the purpose for using an escrow in the first place. As mentioned previously, in the typical escrow agreement, the funds are placed in escrow by the buyer to ensure that his money is protected while he is waiting for the seller to complete his end of the bargain.<sup>64</sup> The escrow holder

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59. Appellee Brief, *supra* note 56, at 18.

60. *Bio-Electronics*, 268 Neb. at 257-58, 682 N.W.2d at 253.

61. *Id.*, 682 N.W.2d at 252-53; *see supra* text accompanying notes 55-56.

62. *See Bio-Electronics*, 268 Neb. at 257-58, 682 N.W.2d at 252-53.

63. *Id.* at 258, 682 N.W.2d at 253.

64. *See Walker & Eshee, supra* note 1, at 45.

is certainly acting as the buyer's agent in such a case.<sup>65</sup> Here, the seller, C & J Partnership, was technically the legal owner of the funds at the time they were placed in escrow. So why would the funds have been placed in escrow at all if the only logical reason for doing so would have been to protect them from being prematurely taken by C & J Partnership? Surely the escrow holder was not acting as C & J Partnership's agent to protect it from itself. And surely, as the owner of the funds, C & J Partnership had every right to take the cashier's check immediately if it so chose.

One can only speculate then, as to why an escrow was in fact used. C & J Partnership stated that the "funds were held in escrow for the protection and convenience of Bio-Electronics until C & J Partnership executed and delivered a warranty deed."<sup>66</sup> Bio-Electronics maintained that because of the long relationship between the two parties, it did not insist on using an escrow.<sup>67</sup> One possible explanation for why the funds ended up in escrow is that, because C & J Partnership failed to uphold its end of the bargain from the beginning and because of the long history between the two parties, it wanted to prove its trustworthiness by choosing not to take Bio-Electronics' money until it could deliver something in return.<sup>68</sup> No matter what the reasoning, the agency theory does not seem to fit very well into these facts. The established law seems to provide no answer to the question of whose agent the escrow holder is when the party supposedly being protected is not the owner of the funds.<sup>69</sup>

Maybe the court did not address the agency theory because it just did not make sense to rely on it under this set of facts. On the other hand, the court's holding could be read as indicating that only the ownership theory is to be used in Nebraska, which would be a much more significant statement. The court should have made clear the reason for completely omitting the agency theory from its decision. Since it did not do so, this decision may cause some confusion in the future of real estate transactions. Now, rather than relying on the proposition that the escrow holder generally acts as the agent of the buyer with respect to his money,<sup>70</sup> the seller in escrow transactions

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65. Some authorities have held that the depositary is *always* the agent of the purchaser. 28 AM. JUR. 2D *Escrow* § 20 (2000); see, e.g., *Angell v. Ingram*, 213 P.2d 944 (Wash. 1950).

66. Appellee Brief, *supra* note 56, at 9.

67. *Bio-Electronics*, 268 Neb. at 255, 682 N.W.2d at 251.

68. In the normal arm's length transaction between strangers, it is generally in each party's best interest to insist on an escrow arrangement. Here, the confusion over the escrow was caused in part by the relationship between the parties and the fact that C & J Partnership may have been more concerned than usual about protecting the buyer's interest, while Bio-Electronics was less concerned than usual that it would be defrauded by the seller.

69. See 28 AM. JUR. 2D *Escrow* § 20 (2000).

70. See *Walker & Eshee*, *supra* note 1, at 45.

should be certain that he does not prematurely accept ownership of property and the liabilities that go along with it.

### C. The Least Innocent Bears the Loss

Lurking behind the dispute over who owned the funds and on whose behalf the agent was supposed to be acting was the issue of which party was more to blame for the loss (other than the agent himself). One of the reasons the roles of the parties in this transaction were so confused was that they had not originally intended to use an escrow. If C & J Partnership had delivered a fully-executed warranty at the scheduled closing as planned, the escrow agent would never have had an opportunity to embezzle the funds.<sup>71</sup> Instead, the money was placed in escrow to be kept until the sale could be completed, setting in motion the events that led to this dispute.

#### 1. *The District Court Opinion*

One of the issues discussed by the trial court, but again omitted by the Nebraska Supreme Court, was Bio-Electronics' argument that because C & J Partnership's delay allowed the escrow agent the opportunity to embezzle the funds, the seller should be held responsible.<sup>72</sup> The district court, of course, only needed to address this question because it found that C & J Partnership did not own the money at the time it was embezzled, and in order to hold C & J Partnership liable, an exception to the general rules of loss allocation must have applied.<sup>73</sup> Since the Nebraska Supreme Court held that C & J Partnership did in fact own the funds, it did not need to rely on the argument that the least innocent of the parties should bear the risk. The issue is still worth examining though, because, in this Author's opinion, it sheds some light on what may have been one of the driving forces behind the court's final decision, even if not outwardly discussed. As the trial court noted, "the rule that as between two innocent parties the loss should fall upon the one who made the loss possible protects only those who exercise ordinary care and caution in performance of duty."<sup>74</sup> The court could have determined that, under this exception, Bio-Electronics should have been protected, as it did everything required of it under the purchase agreement. However, the court found that C & J Partnership was not made responsible by its delay because the delay was not unreasonable.<sup>75</sup> The court noted that in the ordinary real estate transaction, time is not of the essence unless specifi-

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71. Appellant Brief, *supra* note 43, at 15-16.

72. *Id.*

73. Bio-Electronics v. C & J Partnership, No. CI02-568, Order at 6 (Neb. Dist. Ct. Nov. 1, 2002).

74. *Id.* at 7.

75. *Id.* at 8.

cally included in the agreement.<sup>76</sup> The court further explained that when both parties have used ordinary care, the decision rests again on the theories of ownership and agency.<sup>77</sup>

It does seem that Bio-Electronics had a valid argument under the theory that the least innocent of two parties who have been made to suffer by the acts of a third should be the one to bear the loss. The embezzlement of funds was occasioned solely by C & J Partnership's failure to bring a fully-executed warranty deed to the scheduled closing and the fact that another month passed before a serious attempt at obtaining the missing signature was made.<sup>78</sup> However, the district court found that these faults were not serious enough to allow an equitable remedy to interfere with the general rules of loss allocation. Nevertheless, there was still the feeling that Bio-Electronics was being punished for C & J Partnership's mistake, and the theory that the more innocent party should be protected was not quite strong enough to provide Bio-Electronics any relief.

## 2. *The Possible Role of the Least Innocent Theory in the Nebraska Supreme Court's Decision*

Perhaps part of the reason the Nebraska Supreme Court hung its decision so heavily on a technicality, is that it was simply a stronger hook. There would have been much more room for debate if the court had based its decision on the fact that C & J Partnership was the least innocent of the two parties. Whether or not C & J Partnership acted negligently or unreasonably in its failure to produce the necessary warranty deed seemed to be a very close call. By basing the decision instead on the Nebraska U.C.C. and the ownership theory, the Nebraska Supreme Court handed down a decision that was more authoritative, and also in line with the underlying equitable considerations.

Because more importance is generally placed on ownership as a basis for allocation of loss,<sup>79</sup> a finding that funds definitively belonged to one party and not the other is more irrefutable than a weak argument based on the least innocent principle. In this way, the court was able to reach what seems to be the more "just" result without turning to the equitable principle that the least innocent party should bear the

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76. *Id.* at 7; *cf.* *Majors v. Butler*, 221 P.2d 994 (Cal. Dist. Ct. App. 1950) (holding that a seller's failure to obtain a proper warranty deed was negligent when the escrow agreement required that the deed be delivered within thirty days).

77. *Bio-Electronics v. C & J Partnership*, No. CI02-568, Order at 7 (Neb. Dist. Ct. Nov. 1, 2002).

78. *See supra* note 45 and accompanying text.

79. Flores, *supra* note 4, at 352 ("Most [states] turn to the ownership terminology of *Hildebrand* . . . . Treatises seem to favor the ownership theory, and that is the position of the Restatement (Second) of Agency . . . .").

risk of loss, a principle that most likely would not have yielded the more equitable result.

## V. CONCLUSION

The Nebraska Supreme Court reached the correct decision in ruling that under the unusual set of circumstances involved in *Bio-Electronics*, the buyer of the property should not have been made to bear the loss of funds embezzled from the escrow account in which they were held. In reaching this conclusion, the court properly applied the Nebraska U.C.C. to the facts of the transaction: Bio-Electronics transferred ownership of the funds to C & J Partnership prior to their placement in escrow. Thus, as the owner and depositor of the funds, the seller, C & J Partnership, had to bear the burden. The court's decision, however, rested solely on a technicality without elaboration on any of the theories or policies generally employed in resolving disputes over embezzled escrow funds.

The court leaned heavily on the theory that the owner or depositor of the funds held in escrow should be made to bear the burden of the loss.<sup>80</sup> In so deciding, the court ignored the conflict its decision created between the ownership theory and its counterpart involving agency.<sup>81</sup> In the usual case, the buyer maintains ownership of his money when it is deposited into escrow. The escrow holder accordingly acts as the buyer's agent, protecting his funds until the seller has delivered on his end of the bargain. The result under these circumstances would be the same no matter which theory was used. The buyer would bear the loss as the owner of the funds, or as the principal of the agent who embezzled them. In virtually all standard escrow cases, the theories of ownership and agency act in harmony, leading to one rule that the party who is entitled to the funds at the time of their embezzlement must bear the loss.<sup>82</sup>

In the instant case, under the ownership theory, the seller was forced to bear the loss, whereas under the agency theory, it seems more likely that the buyer would have had to bear the loss as the party who was to be protected by the escrow holder. Because of this inconsistency, it appears that the agency theory was sacrificed to the more prevalent ownership theory. Yet upon closer inspection, one may infer that there was something else going on beneath the court's one-dimensional reasoning. Perhaps at the foundation of the court's decision was the general principle that "where one of two innocent parties must suffer by the acts of a third, he whose conduct, act, or omission enabled such third person to occasion the loss must sustain

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80. *Hildebrand v. Beck*, 236 P. 301, 303-04 (Cal. 1925).

81. *Shreeves v. Pearson*, 230 P. 448, 453 (Cal. 1924).

82. *Flores*, *supra* note 4, at 352.

it.”<sup>83</sup> This possibility suggests that the court decided that the “just” result in this case would be to protect the party who was the most innocent, then crafted a legal argument to support the desired outcome based on a stronger theory. If, alternatively, the court really intended to disregard the agency theory in favor of loss allocation based on ownership, it should have explained more clearly the rationale behind its decision, rather than simply ignoring valid agency arguments and taking a purely mechanical approach.

While the court’s holding has created an inconsistency between the two theories, it will most likely be limited to situations where ownership of the funds changes hands before the escrow is created, as in *Bio-Electronics*. Other cases arising in the same way will surely be very rare. Generally, no buyer in an arm’s length transaction would permit the seller to gain possession of the purchase money prior to the time when the seller has delivered on his end of the bargain, as *Bio-Electronics* apparently did.<sup>84</sup> The incentives for the buyer not to relinquish control of his funds are self-evident. The lesson of this case seems to be that it is also in the seller’s best interest not to prematurely take ownership of the funds, lest he take on the burdens that come with ownership before he is ready.

In the typical escrow arrangement, where the parties are clear about their intentions and expectations in using the escrow, they will be able to safely rely on the ownership theory endorsed by the court in its holding, and they will obtain the same result as if the agency theory was employed. However, parties must keep in mind the policy concerns that seem to have influenced the court’s decision so they can avoid actions that would cause them to be labeled the least innocent. This factor may be the deciding one, regardless of whether or not it is outwardly expressed.

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83. *Scottsbluff Nat’l Bank v. Blue J. Feeds, Inc.*, 156 Neb. 65, 83, 54 N.W.2d 392, 403 (1952).

84. *See supra* note 66 and accompanying text.