The Wet Settlement Act and the Problem of Delayed Disbursements

Lynda L. Butler

William & Mary Law School, llbutl@wm.edu
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DELAYED DISBURSEMENTS

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Prior to 1978, attorneys conducting residential real estate transactions often found that the disbursement of proceeds of the transactions was delayed for a substantial period of time after settlement. Typically, the delay resulted from the practice of disbursing funds only after the presentment and final payment of settlement checks. In 1978 the General Assembly adopted the first piece of legislation designed to deal with this problem of delayed disbursements. See Act of Apr. 10, 1978, ch. 823, 1978 Va. Acts 1416. Because of the ambiguous wording of the 1978 statute, the General Assembly repealed the statute in 1980 and replaced it with the Wet Settlement Act. Since its adoption in 1980, the Wet Settlement Act has been amended on several occasions, but the basic components of the 1980 version remain in force today. See Va. Code §§ 6.1-2.10 to -2.15 (1983 & Supp. 1985).

Although the adoption of the Wet Settlement Act has helped considerably to shorten the time between settlement and the disbursement of proceeds, problems of interpretation and application still remain. Most of those problems surround the meaning of the phrases "disbursement of loan funds" and "disbursement of settlement proceeds." Because of the uncertainty of those phrases, the duty of a settlement attorney under the Wet Settlement Act and under the Virginia Code of Professional Responsibility is confusing and at times conflicting and untenable. The following discussion focuses on some of the problems still faced by the settlement attorney.

The Duty of the Settlement Attorney under the Wet Settlement Act

Under the Wet Settlement Act, a settlement attorney involved in a residential real estate transaction has the duty to "cause disbursement of settlement proceeds within two business days of settlement." Id. § 6.1-2.13 (1983). The "disbursement of settlement proceeds," in turn, is defined as "the payment of all proceeds of the transaction by the settlement agent to the persons entitled thereto." Id. § 6.1-2.10 (Supp. 1985). The duty of the settlement attorney thus involves the payment of all proceeds of the transaction to appropriate parties within two business days of settlement.

Other than the concise definition of "disbursement of settlement proceeds" found in § 6.1-2.10, no further guidance is given in the Wet Settlement Act on the duty of the settlement attorney to disburse settlement proceeds promptly. Key terms like payment and proceeds are not defined. Under basic principles of commercial law, the term "payment" generally refers to the process by which a drawee bank becomes irrevocably committed to or accountable for an item. See id. § 8.4-213 (1965). A drawee bank becomes irrevocably committed to settling for an item when it pays the item in cash, settles for the item without reserving a right to revoke the settlement, completes the process of posting the item, provisionally settles for the item and then fails to revoke the settlement in the time and manner prescribed by statute, clearing house rule or agreement, or simply fails to act on the item within the time allowed after receipt of the item. Id. §§ 8.4-213(1), 8.4-302. Under these principles, the statutory duty of the settlement attorney to disburse settlement proceeds arguably would require the attorney to cause the proceeds to be finally settled and paid within two business days of settlement. Where the proceeds are represented by a check, this requirement at least would mean that the attorney would have to cause the drawee bank to become irrevocably committed to paying the check within two business days of settlement.
The definition of the phrase "disbursement of loan funds" further supports this interpretation. The definition currently provides that loan funds are disbursed upon the delivery of the loan funds by the lender to the settlement agent in one or more of the following forms:

1. Cash;
2. Wired funds;
3. Certified check;
4. Checks issued by a political subdivision of the Commonwealth;
5. Cashier's check;
6. Checks issued by a financial institution, the accounts of which are insured by an agency of the federal or state government, which checks are drawn on a financial institution located within the Fifth Federal Reserve District, the accounts of which are insured by an agency of the federal or state government;
7. Checks issued by an insurance company licensed and regulated by the State Corporation Commission, which checks are drawn on a financial institution located within the Fifth Federal Reserve District, the accounts of which are issued by an agency of the federal government; or
8. Checks issued by a state or federal savings and loan association or savings bank operating in the Commonwealth, which checks are drawn on the Federal Home Loan Bank of Atlanta.

Id. § 6.1-2.10 (Supp. 1985). The phrase "loan funds," in turn, is defined as the "gross or net proceeds of the loan to be disbursed by the lender at loan closing." Id. The lender has the duty to disburse the loan funds "at or before loan closing." Id. § 6.1-2.12 (1983).

Because the definition of "disbursement of loan funds" refers to the "delivery," instead of the "payment," of loan funds, it would appear that the legislature intended the duty of the lender to be less demanding than the duty of the settlement attorney. Unlike the settlement attorney, the lender only has to deliver or transfer the proceeds of the loan to the settlement agent in one of the prescribed forms. Since those prescribed forms include certain types of commercial paper that have not been finally settled or paid, and since only delivery is required, the lender does not have to cause the drawee bank to become accountable for proceeds represented by loan checks. In contrast, the settlement attorney would have to cause the payment of proceeds for items taken in one of the prescribed forms within two business days of settlement. The difference in the duties of the lender and the settlement attorney can put the attorney in an almost impossible position.

If payment is defined as meaning the process by which a drawee bank becomes irrevocably committed to settling for an item, then a diligent settlement attorney could easily breach the § 6.1-2.13 duty to disburse. Most of the items listed as permissible forms of proceeds are not items that would be finally settled by a drawee bank at the time of their deposit by the settlement attorney. Further, if the item is a check drawn on an out-of-state bank, the payment process could take many days, and while waiting for a final settlement the depositary bank could decide to put a hold on the item. Under
principles of commercial law, such a hold could last well beyond the settlement attorney's two-day deadline. The drawee bank generally has until midnight on the next banking day following the banking day on which it received a check for payment to return the item and send written notice of dishonor. See id. §§ 8.3-508(2), 8.4-104(1)(h), 8.4-301(1), 8.4-302(a) (1965 & Supp. 1985). Further, other banks involved in the collection process for the same item then have until their midnight deadline or within a reasonable time after they learn of the dishonor to revoke any provisional settlement made for the item and to return the item with notice of dishonor. See id. §§ 8.3-508(2), 8.4-104(1)(h), 8.4-212(1) (1965 & Supp. 1985). Thus, if the depositary bank decides to put a hold on a loan or settlement check while waiting for final payment or notice of dishonor, the settlement attorney may find it impossible to meet the § 6.1-2.13 duty to disburse.

Besides defeating the purpose of the Wet Settlement Act, this delay also would raise serious questions of ethical misconduct by the attorney.

The Duty of the Settlement Attorney under the Virginia Code of Professional Responsibility

Disciplinary Rule 9-102(B)(3) of the Virginia Code of Professional Responsibility requires an attorney to "[m]aintain complete records of all funds, securities, and other properties of a client coming into the possession of the lawyer and render appropriate accounts to his client regarding them." Further, under Disciplinary Rule 9-102(B)(4), an attorney must "[p]romptly pay or deliver to the client or another as requested by such person the funds, securities, or other properties in the possession of the lawyer which such person is entitled to receive." In 1980 the Legal Ethics Committee interpreted these disciplinary rules in light of the Wet Settlement Act to conclude that "an attorney who complies strictly with the provisions of the Wet Settlement Act ... will not be guilty of unethical conduct." LEO 183. But where an attorney makes disbursements on items deposited in the attorney's trust account "prior to actual crediting" and the items "do not take the forms prescribed in the Wet Settlement Act," the attorney's actions "will constitute unethical conduct in violation of Disciplinary Rule 9-102." Id.

In justifying its distinction between items that qualify as one of the forms prescribed in the Wet Settlement Act and those that do not, the Legal Ethics Committee focused on the risk of noncollectability. As explained by the Committee in LEO 183, a settlement attorney may disburse upon funds taking the forms prescribed in the Wet Settlement Act, even though the forms are not collected in a commercial banking sense at the time of deposit by the settlement attorney, because the "risk of noncollectability is so slight as to make it unnecessary to restrict a settlement attorney's ability to disburse." LEO 183. The prescribed forms were regarded as "completely reliable." Id. Further, the Committee believed that "a diligent settlement attorney who presents funds in these forms to his bank with a request that such bank extend immediate credit upon deposit in his trust account will be accommodated by the bank." Id.

But where the settlement attorney makes a disbursement "upon a check of a lender or purchaser not within the forms prescribed in Section 6.1-2.10 prior to actual crediting irrevocably of such check to the settlement attorney's trust account," the attorney would be acting unethically. Id. As the Committee explained, "the payment by the drawee bank of trust account checks drawn by the settlement attorney against such uncollected items will necessarily be made from funds of other clients of the attorney who are not even parties" to the particular real estate transaction. Id. Further, because the uncollected items would not comply with the Wet Settlement Act, the attorney would be exposing his clients to a potentially serious risk of harm.
An apparent implication of LEO 183 is that an attorney who did not get his bank to extend immediate credit upon deposit in his trust account would not be a diligent attorney. Thus, where the attorney's bank put a hold on an item taking one of the prescribed forms, causing payment of settlement proceeds to be delayed beyond the two-day statutory period, the settlement attorney apparently would be guilty of ethical misconduct. Besides failing to comply with the Wet Settlement Act, the attorney also would not appear to qualify as a diligent attorney, as defined by LEO 183.

More recently, the Legal Ethics Committee clarified the earliest time when an attorney could make disbursements upon items falling within § 6.1-2.10 of the Wet Settlement Act. In LEO 751, the Legal Ethics Committee concluded that "[i]t is improper for an attorney to deliver sale proceeds or commission checks at closing prior to the bank deposit of the disbursable funds although the disbursement checks are dated the following business day, or the disbursement checks are dated the date of closing and delivered with the instruction not to negotiate the check until the disbursable funds are deposited by the attorney." LEO 751. The Committee admittedly did not distinguish between items falling within § 6.1-2.10 and those not meeting the Wet Settlement Act. But, in LEO 183, the Committee already had established that disbursements upon checks not within the forms prescribed in § 6.1-2.10 were unethical if made prior to the irrevocable crediting of the checks to the settlement attorney's trust account. See LEO 183. Such crediting clearly would occur after depositing. Thus, the primary impact of LEO 751 on a settlement attorney's duties under the Wet Settlement Act and the Virginia Code of Professional Responsibility would be to clarify one of the unspoken assumptions of LEO 183: that items meeting § 6.1-2.10 standards at least must be deposited before disbursements may occur.

The Commercial Law Implications of Real Estate Settlements

Much of the tension between the Wet Settlement Act and the Virginia Code of Professional Responsibility arises from the commercial law implications of items used in the settlement of real estate transactions. Both the Wet Settlement Act and LEO 183 attempt to minimize the delay between the deposit and the disbursement of funds. To accomplish this goal, they define the duty of the settlement attorney in terms of the risk of noncollectability of items taken in the settlement process. Those items that raise only a "slight" risk of noncollectability, like certified checks and cashier's checks, are identified in the Wet Settlement Act as acceptable forms for the disbursement of loan funds. Further, a settlement attorney's actions in disbursing upon those low risk items after depositing them in his trust account are defined as ethical even though the disbursement is made prior to final crediting.

Unfortunately, principles of commercial law define the consequences of taking commercial paper in more absolute terms. Those principles focus on the irrevocability of a bank's actions, and not on the risk of noncollectability for a particular item. As explained earlier, a bank does not become accountable for an item until final payment has occurred or until the bank has failed to act in the prescribed time and manner. Further, if a depositary bank permits withdrawal against an item for which there is only a provisional credit, the bank faces potentially serious liability if the item ultimately is dishonored. Thus, until an item has been finally settled or paid, a bank is wise to adopt a general policy of not permitting withdrawals against the item.

Even cashier's checks and certified checks present some risks to a depositary bank that is not also the drawee bank. A cashier's check is created when a check's drawee bank also is the drawer. A certified check is a check that has been accepted in advance
by the drawee bank. See Va. Code § 8.3-411(1) (1965). In both situations the drawee bank generally is considered to be primarily liable on the instrument. See id. § 8.3-413(1). See generally Beane, "Rights of Drawers, Banks, and Holders in Bank Checks and Other Cash Equivalents," 19 Tulsa L. J. 612 (1984). Thus, even though the drawee bank subsequently dishonors a cashier's check or a certified check, the holder will have a cause of action against the bank and normally should prevail.

The direct liability of the drawee should protect the holder in most situations. But where the drawee dishonors a cashier's or certified check or is about to become insolvent, the holder may face the prospect of not being able to obtain a refund for value given for the instrument in the near future. Apparently because of this possibility, some depositary banks have adopted a policy of not permitting withdrawal by a customer against any check, even a certified or cashier's check, until the check has been finally paid by the drawee bank. This policy once again means that the settlement attorney may not be able to meet his ethical and statutory duties.

Only a few alternatives presently exist for the attorney attempting to deal with such a policy. One alternative, admittedly impractical at times, is to deal with cash or wired funds. The settlement attorney must accept loan funds delivered by the lender in one of the prescribed forms and generally lacks the ability to persuade lenders to deliver loan proceeds in a form convenient to the attorney. A second alternative is to deal with cashier's checks or certified checks drawn by the depositary bank. Where the depositary bank is also the drawee bank, it generally has less time in which to act. See Va. Code §§ 8.4-301(2), 8.4-302(a) (1965). Further, credit given by the depositary-drawee bank for an item that is finally paid becomes available for withdrawal as of right at the opening of the bank's second banking day following receipt of the item. See id. § 8.4-213(4)(b).

Unfortunately, none of these alternatives may be feasible, depending on the identity and the location of the parties to the transaction. Under such circumstances, the attorney attempting to comply with the Wet Settlement Act may find himself in a catch-22 situation. Absent further legislative reform, that attorney may find that he cannot meet his statutory and ethical duties despite diligent efforts to do so.

Future Solutions: A Request for Your Comments

To evaluate the extent of the hardships imposed on settlement attorneys facing the dilemma described above, we would like to survey the members of the Real Property Section to determine how various banks and other financial institutions handle checks deposited in or drawn on a settlement attorney's trust account for the purpose of closing a residential real estate transaction. If you are aware of a bank or financial institution that refuses to permit withdrawal against a settlement, loan, or trust account check prior to final payment, please inform one of the members of the Board of Governors of the Real Property Section of the practice (preferably one of the editors of this newsletter).

Once we determine how extensive such a practice is, further discussion of possible legislative reforms may become appropriate. To begin such a discussion, we also would like to invite you to submit comments about possible amendments to the Wet Settlement Act. Comments on H.B. 804, which was continued to the 1987 legislative session, would especially be appropriate. In addition, you may wish to comment on the need to redefine the settlement attorney's duty to disburse to make it more consistent with the duty of the lender, with an attorney's ethical obligations, and with relevant commercial practices and law.