Escrow Agreements: The Bankruptcy Effect

A Lexis Practice Advisor® Practice Note by Ira L. Herman, Blank Rome LLP

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This practice note discusses the treatment of escrow agreements in bankruptcy cases. What happens if one party to an escrow agreement files for bankruptcy relief or is the subject of an involuntary case? The overlay of a bankruptcy case on an existing escrow agreement raises three key legal questions. First, is the property subject to the escrow agreement in question property of the bankruptcy estate, pursuant to Section 541(a)(1) of the Bankruptcy Code? Second, is the escrow agreement an executory contract that the trustee may assume or reject under Section 365(a) of the Bankruptcy Code? Third, was the transfer of property into the escrow a voidable transaction?

This practice note discusses the answers to these questions and related issues as follows:

- Escrow Agreement as Property of the Estate
- Escrow Agreement Used as Payment Mechanism to Account for a Contingency (Executory Contract Risk)
- Escrow Account as Security
- Escrow Accounts and Article 9 Security Interests
- Automatic Stay
- Voidable Transfers

For related information, see Property of the Estate and Assumption, Assignment, and Rejection of Executory Contracts.

Escrow Agreement as Property of the Estate

Whether property being held in escrow when a case is filed under the Bankruptcy Code constitutes property of the estate is a mixed question of state and federal law. To determine whether an escrow is property of the estate, courts initially consider applicable non-bankruptcy law (i.e., state law). Specifically, a bankruptcy court will seek to determine whether the estate holds a legal or equitable interest in such property or whether the estate's equitable interest is contingent upon the occurrence of future events or conditions. The nature and circumstances of the escrow arrangement often control. Factors considered by various courts include whether the debtor entity initiated or agreed to the creation of the escrow, whether the debtor entity exercises any degree of control over the escrow, the source of the funds that have funded the escrow, the beneficiary of the escrow, and finally, the purpose of the escrow. "[M]erely labeling a specific delivery of property as an escrow . . . does not give such characteristic to the particular transaction." Am. Serv. Co. v. Henderson, 120 F.2d 525, 530 (4th Cir. 1941).

After determining the nature of an estate's interest in an escrow, courts consider whether the escrow constitutes property of the estate. The definition of the term property of the estate employed by Section 541 of the Bankruptcy Code is very broad in scope, as it encompasses conditional, future, speculative, and equitable interests of a debtor in the property in question. It is settled law, however, that property of the estate can be no greater in scope than the property interests of the debtor as they existed on the petition date. Pursuant to Section 541(d) of the Bankruptcy Code, "property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . .

becomes property of the estate . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold." Accordingly, if, as of the commencement of the case, the debtor has only a contingent right to receive the escrowed property, then only that contingent interest is property of the estate. Whether property deposited into "an escrow constitutes property of a debtor's estate depends entirely on the nature and circumstances of the escrow in question." Elsaesser v. Trefz (In re Taylor), 1995 Bankr. LEXIS 2201, at *10 (Bankr. D. Idaho Sep. 25, 1995). Courts in several jurisdictions have held that an escrow arrangement set up pre-petition providing that an entity is entitled to payment after satisfying certain conditions to be outside of the bankruptcy estate, with only the estate having a contingent right to recover the funds only upon satisfying the escrow conditions. It is important to note that the outcome regarding different escrow arrangements in different jurisdictions may differ due to differences in the applicable state laws governing escrow arrangements. See sample Escrow Agreement Clause (Identifying and Managing Bankruptcy Risk).

Escrow Agreement Used as Payment Mechanism to Account for a Contingency (Executory Contract Risk)

When parties to an escrow intend the account to be the source of payment, they presumably agree that the amount to be paid will be paid out of the account at a closing. The payment could be the price for a parcel of real property or payment on account of a settlement agreement, etc.

When a bankruptcy trustee argued that an escrow agreement was an executory contract and could be rejected by the trustee, the Eighth Circuit held that the escrow agreement was not an executory contract because (1) the agreement was more than a contract, it was a way to convey property, and the ultimate grantee acquired an interest in the property when the funds were deposited in escrow and (2) alternatively, even if the escrow agreement were a contract, it was not executory with performance remaining due on both sides at the time of the bankruptcy petition because payment of money was all that remained to be done. In re Newcomb, 744 F.2d 621 (8th Cir. 1984).

Escrow Account as Security

When parties intend an escrow agreement to create a security interest related to the purchaser's payment obligation under a credit sales contract, the escrow agreement still is not an executory contract. In *In re Cedar Rapids Meats*, the debtor entity established an escrow account to secure its obligation to pay workers' compensation claims. Ultimately, the bankruptcy court followed the reasoning of *In re Newcomb* and concluded that the escrow agreement was not an executory contract. In re Cedar Rapids Meats, Inc., 121 B.R. 562 (Bankr. N.D. Iowa 1990). As an additional rationale, the bankruptcy court in *Cedar Rapids* stated that even if the escrow agreement were an executory contract, rejection of the escrow agreement was not appropriate because it would fail the test of benefiting the unsecured creditors. The unsecured creditors would not have benefited because the escrow funds were not property of the estate or, alternatively, if the funds were property of the estate, they were subject to a perfected security interest.

Escrow Accounts and Article 9 Security Interests

How do you set up an escrow account to protect its contents from being siphoned into the future bankruptcy of the counterparty to the escrow? The lesson of In re Vienna Park Properties, 976 F.2d 106 (2d Cir. 1992) is instructive regarding what not to do as a lender. The facts of Vienna Park are straightforward. First, the debtor, through a manager of its choosing, had discretion over spending funds in an escrow account. Second, (1) the lender took a lien on the funds in the escrow account and the debtor's residual interest in those funds, and (2) the escrow terminated upon satisfaction of the debtor's obligations to the lender. The lender failed to perfect its security interests (apparently assuming it was perfected by possession, even though the funds were on deposit in a third-party bank). The result was that lender's lien was avoided, and the funds were available for the estate to use in its Chapter 11 case.

In contrast, in In re Expert S. Tulsa LLC, 619 F. App'x 779 (10th Cir. 2015), the 10th Circuit affirmed a Bankruptcy Appellate Panel opinion, In re Expert S. Tulsa LLC, 522 B.R. 634 (B.A.P. 9th Cir. 2014), holding that the parties created a true escrow under Oklahoma law, because (1) the conditions for disbursement from the escrow were objective and beyond the discretion of the debtor, as it could receive funds only when it completed a segment of certain improvements to its real property, an objectively verifiable situation beyond its discretion and (2) disbursement from the escrow did not reduce the debtor's obligation to the counterparty; rather, the funds in escrow were being used to pay the debtor for work it was required to perform. Thus, the terms of the escrow arrangement are outcome determinative. Set up the account in question as a true escrow; the result will be that the property in the escrow will be outside any bankruptcy estate. Set up the escrow so that it is a disguised cash collateral arrangement; the result will be that the property in escrow is treated as property of the estate. Of course, as state law governs the establishment of an escrow arrangement, in any given specific situation, the relevant state law may prescribe additional requirements to properly create a true escrow and keep an escrow from becoming property of the estate in a future bankruptcy case. A good example of the application of state law concepts may be found in In re Price, 589 B.R. 690 (D. Haw. 2018). "Under Hawaii law, an effective escrow agreement must define the granting condition, which when satisfied, requires the escrow holder to deliver the escrowed property to the grantee." 589 B.R. at 702–03 (citing Whitlow v. Jennings, 40 Haw. 523, 530 (Haw. 1954)), aff'd sub nom, Coulson v. Kane, 773 F. App'x 893 (9th Cir. 2019).

Automatic Stay

The automatic stay will serve to deny access to an escrow if it is determined that the escrow is property of the estate under Section 541 of the Bankruptcy Code. For further information about the impact of the automatic stay generally, see Automatic Stay.

Voidable Transfers

There is a risk that a transfer of property to an escrow account prior to the commencement of a bankruptcy case will be avoided as a preference under Section 547 of the Bankruptcy Code, or as a fraudulent transfer under Section 544 of the Bankruptcy Code and Section 548 of the Bankruptcy Code.

If an escrow arrangement is not set up correctly under the applicable non-bankruptcy law, a subsequent transfer out of the escrow may be subject to avoidance as a preferential transfer under Section 547. For example, a transfer out of an escrow could not be avoided under Section 547 where the debtor's property interest in the funds placed in escrow was diminished at the time the escrow was created, such that a subsequent funds transfer "did not deprive [D]ebtor's estate of anything of value." See In re Tenderloin Health, 849 F.3d 1231, 1244 (9th Cir. 2017) (citations and internal quotation marks omitted). However, where an escrow instruction preserved the status quo, rather than altering it, the escrow deposit did not affect the transfer of the property and the only relevant transfer for the purpose of the Section 547 preference analysis occurred when the property was transferred out of the escrow. In re Price, 589 B.R. at 702. This same principle will apply in the context of other voidable transfers, including fraudulent conveyances. For further information about the avoidance actions available to a trustee or debtor-in-possession, including preferences and fraudulent transfers, see Preferences and Fraudulent Transfers.

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Ira Herman is a Partner in Blank Rome's New York office. He concentrates his practice on domestic and cross-border insolvency matters, commercial litigation, and related corporate governance issues. He regularly represents buyers of distressed assets and provides counsel concerning troubled commercial real estate, including securitized loans (CMBS). As a mediator, Ira has been able to facilitate the resolution of controversies involving U.S. and non-U.S. parties concerning bankruptcy and commercial law issues. Additionally, Ira works with for-profit and nonprofit entities on data privacy and cybersecurity issues.

Currently he serves as Steering Committee Chair for the New York City Bankruptcy Assistance Project. He is a member of the President's Council for the Food Bank for the City of New York. He is the Editor-in-Chief of the American Bankruptcy Institute's (ABI) Section 363 Asset Sales Databank and Co-Chair of the ABI Assets Sales and Real Estate Committees. Ira is an Adjunct Professor of Law at Pace University School of Law and St. John's School of Law in the Bankruptcy LL.M. Program.

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