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Are escrowed funds property of the bankruptcy estate?

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Whether property in an escrow account established by a debtor pre-petition is property of the debtor's bankruptcy estate is a question of both state and federal law, and case law is divided on this issue. To determine whether such property is part of the debtor's bankruptcy estate, courts first consider, as a matter of state law, what rights the debtor holds in the property at the time the bankruptcy petition is filed. Specifically, the court seeks to determine whether the debtor holds a legal and/or equitable interest in the property, or whether the debtor's equitable interest is contingent upon the occurrence of future events or conditions. To make this determination, the nature and circumstances of the escrow arrangement often control. Factors that courts have found relevant include whether the debtor initiated and/or agreed to the creation of the escrow, what if any control the debtor exercises over the escrow, the source of the funds in the escrow, the beneficiary of the escrow, and the purpose of its creation.

After determining the nature of the debtor's interest in the property, courts then consider, as a matter of federal bankruptcy law, whether the property is part of the debtor's bankruptcy estate. Under the Bankruptcy Code, Â§ 541(a)(1), all of the debtor's legal and equitable interests are transferred to the bankruptcy estate at the time the bankruptcy petition is filed. The property of a bankruptcy estate is intended to be broadly defined, and encompass conditional, future, speculative, and equitable interests of the debtor. It is settled law, however, that the property acquired by the estate can be no greater than that which the debtor had on the petition date. Pursuant to Bankruptcy Code, Â§ 541(d), "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. As one court noted, to hold otherwise would effectively "convert debtor's contingent right [to the fund] into a non-contingent right."

Courts in several jurisdictions have held escrows, into which a pre-petition debtor puts its property, or from which such debtor is entitled to payment after satisfying certain conditions, to be outside of the debtor's bankruptcy estate. In re Atlantic Gulf Comtys., 369 B.R. 156, the court held that funds in an escrow account are not property of the estate even where the funds were deposited by the debtor. Only the debtor's contingent right to recover the funds upon satisfying the escrow conditions is considered estate property. See also 322 B.R. 610; 93 B.R. 508; 304 B.R. 566. According to one court, "most courts have held that assets in escrow are not property of the estate, even though the debtor may have certain rights under the escrow agreement and, therefore, in the assets escrowed." But see 2003 U.S. Dist. LEXIS 13163.

A holding that funds, escrowed by a commercial real estate borrower pre-petition, are outside of the borrower's bankruptcy estate, would comply with and enforce the agreement of the borrower and commercial real estate lender relative to the funds. Borrowers are often required to fund escrows to finance costs such as future capital and tenant improvements, environmental remediation work, or debt service. The borrower's right to receive the escrowed funds is typically contingent upon the satisfaction of certain conditions, and the avoidance of an event of default. Based upon the aforementioned case law, in a bankruptcy proceeding lenders have a powerful and good faith argument that the borrower's bankruptcy estate should include only the borrower's contingent right to receive the escrowed funds upon satisfying the escrow conditions, and not the funds themselves. Carefully structuring the escrow arrangement to, among other things, restrict borrower's access to the funds, clearly detail the conditions to borrower's receipt of the funds, and terminate borrower's right to receive the funds upon the occurrence of an event of default, as well as incorporating into the financing documentation a provision whereby the parties agree that the borrower's bankruptcy estate shall include only the borrower's contingent right to receive the funds, will only benefit a lender seeking to establish this position in a bankruptcy proceeding.

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