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2009 **Volume I** **No. 23**

Case Analysis of *In re Atlantic Gulf Comtys. Corp.*

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Question Presented

Whether a bankruptcy estate should encompass escrow accounts funded by the debtor, where the debtor deposited the funds into the account and is the designated recipient of the funds once a certain condition is met.

Introduction

In *In re Atlantic Gulf Comtys. Corp.*, a Delaware Bankruptcy Court applied New York law to both equitable and legal arguments made by the debtor, holding that funds in an escrow account created by the debtor were *not* property of the debtor's estate. 369 B.R. 156, 164–65 (Bankr. D. Del. 2007). First, this memo will examine the two opposing legal and equitable arguments made by the parties, with each relying on different theories of characterizing the debtor's interest in escrow accounts as they have evolved throughout New York caselaw. Second, it will analyze the contingency argument made by the department, which primarily relied upon law from a similar case in another jurisdiction. Third, it will discuss decision made by the Delaware Bankruptcy Court, including the reasoning adopted by the Court. Finally, it will conclude by alluding to the broader implications of this case, as it could provide guidance for the future of New York law in this area as well as providing practical advice on how to protect the interests of those developers who rely on the use of escrow in real estate transactions on a regular basis.

Cite as: *Case Analysis of In re* Atlantic Gulf Comtys. Corp., 1 ST. JOHN'S BANKR. RESEARCH LIBR. No. 23, at 1 (2009), http://www.stjohns.edu/academics/graduate/law/journals/abi/sjbrl/volume/v1/Mahar.stj (follow "View Full PDF").

General Information

At issue in *Atlantic Gulf* is whether money placed into an escrow account by the debtor should be given over to the debtor's bankruptcy estate. *Id.* at 160. Though the debtor first filed a voluntary chapter 11 proceeding, it was converted to a chapter 7. *Id.* at 159. Subsequently, a trustee in bankruptcy was appointed to manage the process of liquidating the debtor's assets in order to satisfy its creditors. *Id.* at 160–61. Not all of the debtor's property is automatically considered part of the bankruptcy estate; therefore, an essential function of the trustee is to determine what property comes into the estate and what remains unreachable by its creditors. *Id.* at 162-63. Section 541(a)(1) of the Bankruptcy Code states that when a bankruptcy case is filed, an estate is created that contains "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. 541(a)(1)(2006). Thus, the resolution of this case turns on whether or not the debtor's interest in the escrow account constitutes a "legal or equitable interest." *Id.*

Discussion

When a debtor files for bankruptcy, the trustee is responsible for liquidating the debtor's assets to pay off creditors. When those assets include escrow accounts containing funds deposited by the debtor, an issue arises as to whether the trustee is entitled to terminate the fund and include it in the bankruptcy estate. The Bankruptcy Court for the District of Delaware confronted this issue in *Atlantic Gulf*, where it held that funds in an escrow account created by the debtor were not considered property of the debtor's estate. 368 B.R. at 164–65. There, the New York Department of State ("department") brought an action to prevent the trustee of a land developer from removing funds from an escrow account created by the developer to construct water and sewer facilities at its homesites. *Id.* at 159. The state had required the company to sign

the escrow agreement before it would allow the developer to sell property to New York residents. *Id.* According to the agreement, the developer would fund the account using a portion of the monthly payments made by the lot purchasers. *Id.* The developer was then authorized to withdraw the funds when it could provide evidence that water and sewage facilities had been built at each site. *Id.* The developer constructed facilities on some of the sites. *Id.* However, following an earlier bankruptcy filing prior to the one at issue in this case, the developer sold its remaining property to other developers and its utility facilities were taken over by the local government. *Id.* Therefore, the developer no longer "has [the] ability to construct water or sewer facilities in those communities." *Id.*

Once the second bankruptcy filing was converted into a chapter 7 proceeding, the trustee entered into a liquidation agreement with the debtor's secured creditors ("Lenders"). *Id.* at 160. The agreement provided that the trustee would liquidate the debtor's assets and use the funds to pay off its secured lenders, with a portion of the money going to general administrative expenses and the debtor's unsecured creditors. *Id.* Once the liquidation was approved by the court, the trustee began the process of liquidating the debtor's assets. *Id.* The trustee filed a motion to dissolve the escrow account and add the remaining funds to the debtor's estate. *Id.* The trustee was required to give notice to 9,000 lot purchasers whose payments to the developer had been used to fund the account. *Id*. The notice stated that the trustee had made a motion to terminate the account and take all remaining funds to be disbursed according to the plan agreed upon for the bankruptcy estate. *Id*. Though the trustee made some payments to lot purchasers who were determined to have valid claims, the department brought action against the trustee to prevent it from terminating the fund, contesting its assertion that it was entitled to the approximately $8.5 million remaining in the account. *Id.*

The trustee argued that the debtor was entitled to the funds under both New York law and section 541 of the Bankruptcy Code, alleging that the debtor retained legal and equitable title to the funds because it was grantor of the funds that went into the account, as well the recipient of the funds once the condition of building the facilities was met. *Id.* at 162–63. The trustee argued that the debtor had legal title because the funds that were deposited into the escrow account were the debtor's property. *Id.* at 162. Furthermore, the debtor had an equitable interest to the escrow account since it was to receive the escrow funds *back* once the water and sewage facilities were completed. *Id.* at 163. To support its argument, the trustee relied on a long line of New York cases. *Id.* at 162. The trustee cited to *In re Drexel Burnham Lambert Group, Inc.*, which clearly states that an "applicable principle" of New York law is that "under New York law legal title to property placed in escrow remains with the grantor until the occurrence of the condition specified in the escrow agreement." 138 B.R. 687, 710 (Bankr. S.D.N.Y. 1992) (quoting *In re O.P.M. Leasing Servs., Inc.)*, 46 B.R. 661, 667 (Bankr. S.D.N.Y. 1985). In that case, an escrow account contained bonds purchased by an employee that were subject to a condition that the employer would be able to repurchase them if the employee was ever terminated for cause. *Id.* The employer went into bankruptcy and tried to claim that it had a legal interest to the escrowed bonds. *Id.* The court found that the employee a legal interest in the bonds because the employee was the party who purchased them and placed them in the escrow account: "the [employer's] only prepetition interest in the portfolios was a contingent right, in the form of a condition subsequent, to repurchase them in the event [the grantor's] employment was terminated for cause." *Id.* Though the debtor was not the party who funded the account in this case, the principle of law as applied is illustrative of the trustee's argument that the person who granted the account has legal title to the escrowed funds; in fact, the trustee's argument is strengthened

by the fact that it is both the grantor and the grantee, which supports the trustee's equitable argument that it is entitled to the funds because it is the holder of the contingent interest anyway. The trustee also cited to another example, in *Alexander v. Quality Leather Goods*, where the court held that stock title remained in the grantor. 269 N.Y.S. 499, 500. (N.Y. Sup. 1934). There, the director of a company agreed to sell his interest to his two partners. *Id.* He placed his certificate of stock in escrow until his partners had fully paid off the promissory notes that his partners signed to purchase his interest. *Id.* at 500–501. When some of the notes remained unpaid, he removed his certificate of stock and kept it in his possession. *Id.* at 501. Despite the fact that some of the promissory notes *had* been paid, the court found that stock title remained in the original director, because in escrow, title did not pass until the condition had been fulfilled. *Id.* at 502. Similarly, in *Press v. Marvalan Indus., Inc.*, the court addressed an argument involving who had the obligation to pay interest on a promissory note in an escrow account, and noted that "the incidents of ownership remain in the person depositing the property into escrow until the conditions of escrow have been fulfilled." 422 F. Supp. 346, 349 (S.D.N.Y. 1976). In *In re Pan Trading*, the court appears to go even further, asserting that the underlying purpose of an escrow is "to retain an interest in the depositor until the happening of the prescribed contingencies." 125 B.R. 869, 878 (Bankr. S.D.N.Y. 1991).

The department argued that New York law had consistently denied that escrow funds were part of the property of the estate. *In re Atlantic Gulf,* 369 B.R. at 163. It also argued that the property owners also had equitable rights to the fund since it was established for the purpose of constructing facilities to benefit them. *Id.* at 164. They alleged that the debtor had only a contingent right to the funds, depending on whether it fulfilled the condition set forth in the

escrow agreement. *Id.* The department also argued that the debtor's interest in the escrow account was limited to a contingent interest because of the interests of the lot owners. *Id.*

In order to support its claim that the debtor was *not* entitled to the escrow funds under New York law, the department cited to three cases. The first, *TTS, Inc. v. Citibank*, involved another Delaware bankruptcy court applying New York law to determine who had legal title to an escrow account. 158 B.R. 583, 586 (Bankr. D. Del. 1993). That case involved a deferred compensation plan where the employer placed funds into an escrow account that would pay out to an employee upon his retirement or death if he complied with the terms of his employment, adhered to a non-compete agreement, and agreed to the provision of consulting services to the employer upon request. *Id.* at 585. The employer went into bankruptcy and sought to retrieve the funds it had placed in the escrow account. *Id.* The Delaware court relied on section 541(d) of the code, stating that even if the debtor had legal title to the property, where there are "beneficial interests" held by another party, the only interest that is entitled to come into the estate is limited to the rights that the property had before the bankruptcy filing. *Id.* While the court found that the employer "clearly" held legal title to the escrow account, it was "subject to the equitable interest held by [the employee]." Similarly, in *In re Royal Business School, Inc.*, the court refused to turn over an escrow account to a trustee, finding that it only had a "contingent interest" and that to allow the trustee to take the funds from the account would "enlarge the debtor's rights" which should be given no greater weight than they had prior to bankruptcy filing. 157 B.R. 932, 941 (Bankr. E.D.N.Y. 1993). It concluded that this result was logical as it "does nothing more than give effect to the intent of the parties as expressed in the [a]greement." *Id.* at 942. Finally, the court in *In re O.P.M. Leasing Services, Inc.*, stated that the trustee could not include an escrow account as part of the estate "unless the judgment debtor, as grantor, retains an interest in the

escrowed property over and above the interest of the grantee." 46 B.R. 661, 667 (Bankr. S.D.N.Y. 1985). It posited that this was consistent with section 541(d) which limited the debtor's interest after it declared bankruptcy to the interest that it had prior to filing. *Id.*

The department argued that even if the court looked at the circumstances of this case, where the debtor is both grantor and grantee, the trustee was *still* not entitled to the escrow fund under the terms of the escrow agreement, because of the purpose for which it was established, as an "assurance or guarantee fund." *Atlantic Gulf*, 369 B.R. at 164. To support its claim, the department primarily relied upon a Florida case, *In re Palm Beach Heights Dev. & Sales Corp.*, which dealt with an account funded for the purpose of building road and drainage improvements. 52 B.R. 181, 183 (Bankr. S.D.Fla 1985). There, the state had also required that the development company place money into an account to "benefit the land buyers." *Id.* When the development company went into bankruptcy and tried to argue that the account was property of the estate, the court held that the escrow account was not property of the estate, finding that "[a]ny claim, contingency, or chose in action against the trust fund is the property of the estate but the fund itself is not." *Id.* The debtor would only have claim to some of the funds once it was able to "establish[ ] that all prior claims have been paid and that a residuum remains to which it is entitled." *Id.* Since the account was there for the benefit of the people who had purchased the property, the development company could not recover the money in the account until it accounted for their claims. *Id.*

The Delaware Court examined the two major arguments put forth by both the trustee and the department, and found that they did not directly apply to the factual circumstances of this case "where the [d]ebtor is both the grantor and the grantee of the escrow." *Atlantic Gulf*, 369 B.R. at 163. To simply apply the law as stated in these cases, the debtor would retain legal title

as grantee, while the debtor would also maintain an equitable interest as the future recipient of the funds upon fulfillment of the condition. *Id.* The Court found that this conclusion was "not dispositive" of the issue and that the true issue presented by the case was whether the trustee has a "present right" to the money in the escrow account. *Id.* By reconstruing the issue, the Court adopted the majority rule as seen in *In re Palm Beach Dev. & Sales Corp.*, as illustrated in the second argument advanced by the department, that where an escrow account was funded for the benefit of others, those people had an equitable interest in addition to that of the grantee. *Id.* at 164. The Court held that the account was not property of the debtor's estate because it was only entitled to the funds when the condition of constructing the facilities was met. *Id.* The trustee as grantee was not the only party with an equitable interest in the account. Rather, *both* parties had equitable interests, because the state had the account established for the benefit of the lot purchasers, and they had an obvious interest in receiving the services that the development company promised to provide. The Court held that "[t]he filing of a bankruptcy case by the [d]ebtor was not sufficient to divest the lot purchasers of their interest in the escrow." *Id.* It concluded that "the [e]scrow is not property of the estate, even though the contingent interest that the [d]ebtor has in the [e]scrow is property of the estate." *Id.*

Conclusion

The issue of the debtor's interest in funds deposited in an escrow account has not been addressed consistently by bankruptcy courts in New York. The arguments made by the parties in this case are each firmly rooted in New York caselaw. Though the Delaware Court decided to adopt the majority rule in light of its reliance on the department's arguments and similar decisions adopted by the other states, there will not be a decisive conclusion to this issue until the New York courts have had their own opportunity to address these arguments and choose a

definitive rule. It is interesting to note that many of the cases relied upon in this case are decades old, which suggests that this is an area that has been virtually untouched in recent history. Should New York decide to adopt the majority rule, real estate companies who are currently entering into bankruptcy proceedings may find that they have substantially fewer assets than they imagined if their funds are tied up in escrow accounts. This could cripple their ability to pay back their creditors and have long-reaching consequences in the marketplace.

Until that happens, this case provides a great deal of guidance to those real estate developers currently in the marketplace. Legal title remaining in the grantor does not persuasively provide that the money funded by the grantor is a property of the estate. Therefore, those funding accounts may take additional steps to ensure that their interest is protected by making it clear in the escrow agreements that their equitable interest is the superior claim.