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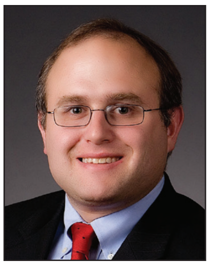
Are Escrow Agreements the Ticket Out of *Midlantic*?



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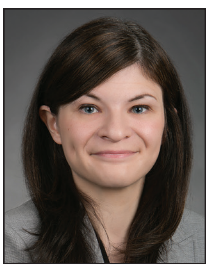

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Through *Midlantic Nat. Bank v. New Jersey Dep't of Envtl. Prot.*,[1] the U.S. Supreme Court held that a bankruptcy trustee was not permitted to abandon property pursuant to 11 U.S.C. § 554(a) when doing so would preempt state or local law that has been "reasonably designed to protect the public health or safety from identified hazards." Further, bankruptcy courts do "not have the power to authorize an abandonment without formulating conditions that will adequately protect the public's health and safety."[2]

This holding was limited in two ways — by specifying that (1) nothing in the opinion considered "whether certain state laws imposing conditions on abandonment may be so onerous as to interfere with the bankruptcy adjudication itself," and (2) the abandonment power under 11 U.S.C. § 554(a) is not meant to "encompass a speculative or indeterminate future violation of such laws that may stem from abandonment [and] is not to be fettered by laws or regulations not reasonably calculated to protect the public health or safety from imminent and identifiable harm."[3] The Court relied, at least in part, on a presumed lack of intent of Congress for the "abandonment power to abrogate certain state and local laws," based on "repeated congressional emphasis on its 'goal of protecting the environment against toxic pollution.'"[4]

Although the *Midlantic* holding appears to be limited to state and local laws, the Court's reasoning has been applied when considering federal law. One well-known example is *In re ATP Oil & Gas Corp.*, in which the bankruptcy court permitted the abandonment of property despite the debtor's failure to comply with federal environmental regulations.[5] The distinct positions between the regulators in *Midlantic* (certain state agencies) and the regulator in *In re ATP Oil & Gas Corp.* (the U.S.) was significant to the bankruptcy court's decision.

Unlike the regulators in *Midlantic*, in *In re ATP Oil* the U.S. agreed to obtain possession of certain properties upon termination of the underlying lease, decommission the properties and thereafter seek reimbursement.[6] Under this agreement, the U.S. would have an administrative claim for the cost of decommissioning.[7] Although the bankruptcy estate would likely be unable to pay the administrative claim, the U.S. could then attempt to pursue ATP's predecessors-in-interest for any and all remaining amounts.[8]

In re ATP Oil is only one case in several that has emerged as a result of *Midlantic*. Aside from the issue of whether *Midlantic* should be applied when considering federal environmental law, a split quickly developed regarding the standard to be applied under *Midlantic*. The minority of courts considering its application have held that a "trustee is prohibited from abandoning property in violation of state environmental laws, even if there is no imminent and identified harm to the public health and safety."[9] On the other hand, the majority has held that "the exception to a trustee's abandonment power set forth in *Midlantic* is limited to situations where an imminent and identified harm to the public['s] health and safety exists."[10] The majority has only continued to grow.[11]

The *In re ATP Oil* court reasoned that had it not allowed ATP to abandon its properties to the U.S., a stalemate would have ensued in which ATP would continue to incur expenses and the potential danger to the public's health and safety would also continue to increase.[12] The court further emphasized that the *Midlantic* Court provided some guidance on whether "precluding abandonment would 'be so onerous as to interfere with the bankruptcy adjudication itself.'"[13] Obviously, a method through which decommissioning costs or similar expenses are paid outside of a bankruptcy estate would be preferable. Along this line, entities should consider creating escrow accounts to hold the funds necessary so that state and federal laws are complied with and ensure the greatest protections for the public generally, despite the conflicts that exist between bankruptcy and environmental law.

1 474 U.S. 494, 507 (1986).
2 *Id.*
3 *Id.*, n.9.
4 *Id.* at 505-06 (listing, in support, Resource Conservation and Recovery Act, 42 U.S.C. §§ 6901-6078, and Comprehensive Environmental Response, Compensation and Liability Act, allowing federal government to secure relief as necessary in order to prevent "imminent and substantial endangerment to the public health or welfare or the environment because of an actual or threatened release of a hazardous substance") (quoting 42 U.S.C. § 9606)).
5 No. 12-36187, 2013 WL 3157567 (Bankr. S.D. Tex. June 19, 2013).
6 *Id.* at *2.
7 *Id.*
8 *Id.*
9 *In re Howard*, 533 B.R. 532, 547 (Bankr. S.D. Miss. 2015).
10 *Id.*
11 *See, e.g., In re Howard*, 533 B.R. 532; *In re Venoco LLC*, 572 B.R. 105 (Bankr. D. Del. 2017).
12 *In re ATP Oil & Gas Corp.*, 2013 WL 3157567 at *3.
13 *Id.* at *2, n.2.

Escrow Accounts in Bankruptcy Cases

Escrow Accounts Generally

When determining whether assets held in escrow are property of a bankruptcy estate, courts often begin their analyses by ascertaining whether the arrangement at issue is a true, valid escrow arrangement under state law.[14] However, the required elements for an escrow agreement concerning an escrow of money are generally (1) an agreement pursuant to which funds are delivered to a third-party depositary; (2) the depositor's relinquishment of control over the funds; and (3) a provision for funds to be delivered to a third party (a beneficiary) conditioned upon the performance of some act or the occurrence of some event.[15]

In addition, to create an escrow, it is typically required that (1) the depositor and beneficiary must agree to all the terms of the instructions; (2) the contract must be so complete that it only remains for the beneficiary or other person to perform the condition, or an event to happen, to give the instrument effect; (3) as in other contracts, the consideration might be mutual stipulations of the parties involving reciprocal rights and obligations (*no enforceable contract with respect to the escrow is created in the absence of a duty, promise or obligation binding the beneficiary as well as the depositor*); and (4) the instrument be actually deposited with a third person by agreement of all parties.[16]

Determining Whether Escrow Accounts Are Property of the Bankruptcy Estate

Escrow accounts have been used for similar purposes in the past. For example, in *In re ANR Advance Transp. Co. Inc.*, the debtor's predecessor (hereinafter "the lessee," and later, "the debtor") leased a freight terminal in Oakland, Calif., from a Colorado corporation (hereinafter "the lessor").[17] During the lease period, underground storage tanks (also leased by the lessee) allegedly caused substantial environmental contamination.[18] The lessee and lessor executed an agreement, pursuant to which the parties agreed to jointly deposit funds into an interest-bearing escrow account to be later established.[19]

The purpose of this escrow account was to cover the payment of costs for the removal of the storage tanks and any remediation attributable to the tanks.[20] Following the terms of the agreement, the lessor deposited $300,000 and the lessee deposited $230,000 with the designated bank.[21] The same agreement "established a procedure for making disbursements from this account for payment for the clean-up costs."[22]

A portion of the funds were disbursed for the removal of tanks and remediation. However, following an investigation, further contamination was discovered.[23] The Port of Oakland subsequently sought recovery from the lessor and ultimately reached a settlement pursuant to which the lessor would pay $850,000.[24] Predictably, the lessor expected partial reimbursement from the escrow.[25] By this time, the lessee had entered bankruptcy proceedings.

The parties did not dispute that if the agreement entered into was a true escrow, the funds in the escrow account would *not* be property of the bankruptcy estate.[26] As a result, the court was left only to determine whether a valid escrow agreement was ever created. The court explained that (1) "the debtor's right in property, including the nature and scope, is determined by state law"; and (2) "whether such interest is 'property of the estate' within the meaning of § 541 ... is determined by federal law."[27]

Overall, a majority of cases demonstrate that a true escrow will not be considered estate property.

The court ultimately found that the lessor and debtor had established a true escrow.[28] In reaching its decision, the court emphasized the necessity of "careful analysis" of the documents purporting to create the escrow. Great weight was given to the "numerous references" throughout the documents to "escrow account," "escrow agent," "monies in escrow" and "escrowed property."[29] When considering the level of control the debtor held over the account, the court explained that "[i]t is the right to withdraw funds and the right to revoke the agreement [that would] constitute the control necessary to invalidate" a true escrow.[30] Although the debtor did have some control over the account, the level of control was insufficient to find that the agreement created anything other than a true escrow.[31]

Most notably, the court commented on the significance that "[n]othing ... indicate[d] [that] the purpose of placing these funds in this account was to gain advantage over claims of unsecured creditors or was in anticipation of a bankruptcy petition."[32] Apparently, precedent established that where a debtor attempted to create an escrow *on the same day* the debtor's board of directors voted to file for bankruptcy, that escrow was ultimately deemed invalid.[33] Consequently, the timing for creating a purported escrow is a factor considered in determining the escrow's validity.

In *In re Atlantic Gulf Cmtys. Corp.*, the court considered whether a true escrow existed under New York law and whether the funds within the account constituted property of the estate where the debtor was both the grantor and grant-

14 *See* 5 *Collier on Bankruptcy* ¶ 541.09 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011); *Noble v. Fed. Ins. Co. (In re Jazzland Inc.)*, 322 B.R. 610 (Bankr. E.D. La. 2005).
15 *See* 30A Corpus Juris Secundum (C.J.S) Escrows §§ 8-11
16 *See id generally.*
17 247 B.R. 771, 773 (Bankr. E.D. Wis. 2000).
18 *Id.*
19 *Id.*
20 *Id.*
21 *Id.*
22 *Id.*
23 *Id.*
24 *Id.*
25 *Id.*
26 *Id.* at 774.
27 *Id.* (citing, *inter alia*, *Butner v. United States*, 440 U.S. 48, 54-55 (1979); *United States v. Whiting Pools Inc.*, 463 U.S. 198, 205 n.8 (1983)).
28 *Id.* at 776. This "escrow agreement" was to be construed under Colorado law, although the court could find only one Colorado case on the subject and so turned to secondary sources and other jurisdictions. *Id.* at 774-75.
29 *Id.* at 775.
30 *Id.*
31 *Id.*
32 *Id.*
33 *Id.* (internal citations omitted).

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ee of the escrow.[34] In this case, the chapter 7 trustee filed a motion to seize the remaining funds in escrow pursuant to § 541.[35] The New York Department of State countered with case law through which courts held that "while [the] debtor retained legal and some equitable interest in funds placed in escrow, the greater equitable interest of the other grantee compelled a conclusion that the funds were not property of the estate."[36] The court explained:

> [A]n escrow into which a debtor puts its property (or from which the debtor is entitled to payments after satisfying a condition) is not property of the estate. Section 541(d)[37] supports this conclusion.
>
> While it is true that the Debtor in this case has some equitable interest in the Escrow, it does not hold all equitable interests.... The filing of the bankruptcy case by the Debtor was not sufficient to divest [other grantees of] their interest.... *Therefore, section 541(d) compels the conclusion that the property acquired by the estate is no greater than what the Debtor had*.[38]

Essentially, while the escrow was not estate property, the debtor's contingent interest in the escrow was estate property. Despite bankruptcy, *the escrow agreement continued to govern the escrow funds*.[39]

Under New York law, if funds are placed by a depositor with a third-party escrow agent for delivery to a beneficiary upon the occurrence of a condition and the depositor goes bankrupt before the condition occurs, courts generally recognize that the depositor still technically has title under New York law to the funds placed in escrow. Nevertheless, the beneficiary has an equitable interest in the escrow funds sufficient to trigger § 541(d), creating a situation whereby the depositor bankruptcy estate's interest in the funds is confined to the rights conferred upon the depositor by the escrow agreement. For this reason, careful crafting of an escrow agreement is essential in order to ensure that escrow funds remain outside the estate.

Conclusion

Overall, a majority of cases demonstrate that a true escrow will not be considered estate property, and as a result, the pre-petition creation of escrow accounts for the purposes of complying with environmental laws might be the solution that entities should seriously consider if the potential for insolvency is even remotely likely. However, the court in *In re ANR Advance Transp. Co. Inc.* addressed a potentially valid concern (purpose and timing of the creation of an escrow).

As for the purpose of an escrow, *Midlantic* and, subsequently, *In re ATP Oil* may provide support for the use of escrow funds as a way to bypass bankruptcy complications. The actual holding of *Midlantic* is that bankruptcy courts do not have the power to authorize an abandonment *without formulating conditions that will adequately protect the public's health and safety*. The court in *In re ATP Oil* used this holding as a basis for its own: permitting abandonment because conditions were in place to uphold the ultimate goal of protecting the public's health and safety.

Arguably, if an escrow agreement is made with an eye for keeping funds out of a bankruptcy estate, the ultimate purpose and goal of protecting the public's health and safety could be found as being paramount. Timing the creation of a true escrow, although potentially significant, might be easily handled. It will be important to stay outside the window for preferential transfers regardless of the circumstances.[40]

Finally, *even if* an escrow is brought into or otherwise considered to be part of the estate, the rules governing the agreement will continue to apply. Thus, it is important that the rules of the escrow be precisely and explicitly set out in order to accomplish its goals. **abi**

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34 369 B.R. 156, 159-60 (Bankr. D. Del. 2007).
35 *Id.* at 160, 162.
36 *Id.* at 163.
37 Providing, in pertinent part, that "[p]roperty 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." 11 U.S.C. § 541(d).
38 *Id.* 164-65 (internal citations omitted).
39 *See id.* at 169.
40 *See* 11 U.S.C. §§ 544, 547(b), 548(a)(1).