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## IS IT IN OR IS IT OUT? DETERMINING THE OPERATIVE TRANSFER DATE FOR ESCROW ACCOUNTS IN PREFERENCE LITIGATION.

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This article examines the limited issue of determining when a "transfer" of personal property occurs in a preference analysis under 11 U.S.C. § 547<sup>2</sup> when monies are flowing in and out of an escrow account.<sup>3</sup> The article does not discuss any applicable defenses to preference litigation.

### I. Background

A typical fact pattern follows:

An agreement is reached for the sale of a debtor's business for \$30,000.00 in cash. On November 29, 2005 escrow is opened and the debtor deposits a bill of sale. The buyer deposits the requisite funds to purchase the debtor's business which are to be released upon the close of escrow. At the same time, escrow instructions are drawn up which include a provision that the entire net proceeds of the sale be transmitted to a third party creditor to satisfy a particular liability owed by the debtor.

Escrow closes on January 8, 2006, whereupon the bill of sale is delivered to the buyer. On January 11, 2006, in accordance with the escrow instructions, the escrow company delivers a check to the creditor for the net proceeds of \$27,500.00. The check is honored by the bank on January 19, 2006.

The debtor files a chapter 7 bankruptcy on April 17, 2006. The 90-day preference period extends to payments or transfers made back to and through January 18, 2006. The trustee claims that the payment to creditor is an avoidable preference. The trustee's ability to prevail in his preference litigation depends on when the transfer occurred. If the transfer took place before January 18, 2005, then the transaction is outside of the preference recovery period.

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<sup>2</sup> All references to sections are to 11 U.S.C. § 101 *et seq.*, unless noted otherwise (the "Bankruptcy Code").

<sup>3</sup> See § 547(e) for a determination of when non-cash items are deemed transferred.

The transfer could be deemed to have occurred:

1. On completion of the debtor's obligations under the escrow instructions, e.g., the delivery of the bill of sale to the escrow holder – November 29, 2005;
2. At the close of escrow – January 8, 2006;
3. When the escrow company's check was delivered to the creditor – January 11, 2006; or
4. When the check was honored by the bank – January 19, 2006.

## II. Definition of a Preferential Transfer

The preference provisions of the Bankruptcy Code serve the bankruptcy policy to create "equality of distribution" among similarly situated creditors of the debtor.<sup>4</sup> To ensure this goal, section 547(b) gives bankruptcy trustees broad authorization to avoid preferential transfers.<sup>5</sup> Transfers that occur within ninety days (for non-insiders) and within one year (for insiders) can be avoided by a trustee as being preferential. One difficulty in analyzing an escrow situation is the determination of what transaction is the operative transfer. Section 547 (b) describes the necessary elements that a trustee must establish to avoid a transfer as preferential.<sup>6</sup> First, there must have been a "transfer" of an interest in debtor's property. The term "transfer" means –

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<sup>4</sup> Valley Bank v. Vance (*In re Vance*), 721 F.2d 259, 260 (9th Cir. 1983).

<sup>5</sup> Union Bank v. Wolas, 502 U.S. 151, 161 (1991).

<sup>6</sup> Section 547(b) provides:

[A] trustee may avoid any transfer of an interest of the debtors' in property –

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made
  - (A) on or within 90 days before the date of the filing of the petition; or
  - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
- (5) that enables such creditor to receive more than such creditor would receive if –
  - (A) the case were a case under chapter 7 of this title;
  - (B) the transfer had not been made; and
  - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

- (A) the creation of a lien;
- (B) the retention of title as a security interest;
- (C) the foreclosure of a debtor's equity of redemption; or
- (D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with –
  - (i) property; or
  - (ii) an interest in property.<sup>7</sup>

The definition of "transfer" is expansive and covers every mode of disposing of an interest in property. The transfer must fall within the applicable "reachback" period under section 547(b)(4) to be avoidable as a preference.<sup>8</sup> Transfers do not occur until they are perfected against third party creditors of the debtor.

### III. Perfection of a "Transfer" Under Bankruptcy Code Section 547 (e)(1)(B)

Whether a particular transaction results in a transfer for purposes of bankruptcy is a matter of federal characterization.<sup>9</sup> Such transfers do not always occur on the same date when the two parties involved in the transaction effect a completed transfer between themselves. In transactions involving the transfer of instruments other than cash, such as a bill of sale, further actions such as recordation may be necessary to establish when a transfer occurred. Under section 547, the time of the transfer may also depend upon determining when the transfer was perfected against third parties.<sup>10</sup>

Section 547 (e)(1)(B) provides that a transfer of a fixture or property other than real property is perfected when "a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee." Certain

<sup>7</sup> 11 U.S.C. § 101(54).

<sup>8</sup> 5 L. King, COLLIER ON BANKRUPTCY, ¶ 547.03[6] at 547-40 (15th ed. rev'd 2006).

<sup>9</sup> Ehring v. Western Community Moneycenter (*In re Ehring*), 900 F.2d 184, 187 (9th Cir. 1990).

<sup>10</sup> 5 COLLIER, *supra* note 8, ¶ 547.05[1] at p. 547-88 (citing *Grover v. Gulino (In re Gulino)*, 779 F.2d 546, 549 (9th Cir. 1985)).

transfers, such as a cash payment by a debtor to a creditor, are perfected as soon as they are made because at that moment these transfers were also perfected as against subsequent judicial liens obtainable against the debtor by creditors on a simple contract.<sup>11</sup> Other transfers, such as security interests, are not ordinarily perfected as against subsequent judicial lienors until some further steps have been taken, such as filing, recording, delivery, or the taking of possession.<sup>12</sup> Therefore, the perfection date is critical to determining when the transfer occurred under section 547(e)(1)(B) because a transfer does not occur until it is perfected.

In order to determine when a creditor fails to acquire a judicial lien superior to the transferee's interest, a court must look to applicable state law.<sup>13</sup> For example, in the case of *In re Eldercare Housing Foundation, Inc.*,<sup>14</sup> the creditors obtained writs of attachment against the debtor. The monies collected by the creditors pursuant to their writ were held to be a transfer as defined by section 101(54).<sup>15</sup> The creditors alleged that their prejudgment writ of attachment acted as a perfection of the transfer of the debtor's interest in the monies under Arizona law. The court disagreed and found that because the creditors failed to obtain a judgment against the debtor prepetition as required under Arizona law, the creditors' writ remained unperfected at the time of filing.<sup>16</sup> The court held that under section 547(e)(2)(C), the transfers were deemed to have been made immediately before the petition date and thus avoidable as a preference.<sup>17</sup>

Escrows present a unique challenge in preference litigation because the operative transfer is not always obvious. The "transfer" could be the placement of monies into the escrow account, or it could be the release of the monies out of the escrow account. Both of these transactions are "transfers" as defined by the Bankruptcy Code, but to determine whether a plaintiff bringing a preference action will prevail, it must be determined which transfer is the operative one. Thus, a review of applicable case law is required.

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<sup>11</sup> 5 COLLIER, *supra* note 8, ¶ 547.05[1][a] at p. 547-88.

<sup>12</sup> 5 COLLIER, *supra* note 8, ¶ 547.05[1][b] at p. 547-89.

<sup>13</sup> *Richards v. Rapid Funding, LLC (In re Richards)*, 336 B.R. 722, 727 (Bankr. E.D. Va. 2004).

<sup>14</sup> *Sysco Foods Co. v. Eldercare Housing Foundation, Inc. (In re Eldercare Housing Foundation Inc.)*, 205 B.R. 210 (B.A.P. 9th Cir. 1996).

<sup>15</sup> *Id.* at 211.

<sup>16</sup> *Id.* at 212.

<sup>17</sup> *Id.*

#### IV. Case Law Outside the Ninth Circuit

##### A. Circuit Decisions

In the case of *Carlson v. Farmers Home Admin. (In re Newcomb)*,<sup>18</sup> the Eighth Circuit found that the relevant "transfer" in terms of analyzing preferential payments was made when funds were deposited into an escrow account.

The court held that when property is delivered into escrow the depositor loses control over it and the interest in the property passes to the ultimate grantee under the escrow agreement.<sup>19</sup> The court examined when the transfer occurred by analyzing Missouri law and held that for purposes of preferential prepetition transfers, the transfer which occurs when an escrow is created is a type of transfer for which no further perfection is possible or necessary under section 547(e)(1)(B). The court found that the transfer was "perfected" when it took effect between the parties. Since the perfection occurred simultaneously, the transfer was deemed made when the escrow was created.<sup>20</sup> As the escrow was created more than ninety days before the debtor filed his petition, the transfer was not avoidable.<sup>21</sup> The Sixth Circuit reached a similar result applying Tennessee law.<sup>22</sup>

##### B. Bankruptcy Court Decisions

The court in *In re Intercontinental Publications, Inc.*,<sup>23</sup> found that because a lien creditor cannot acquire an interest superior to an escrow grantee (applying the standard stated in section 547(e)(1)(B)), the deposit of funds into escrow, rather than release of funds from escrow upon occurrence of certain conditions, is the controlling transfer for preference purposes. In *Intercontinental*, the court, applying Connecticut law, held that an escrow was created when funds from the debtor were deposited into escrow rather than when the check from the escrow agent to grantee was honored, because it was at that point that the funds passed from unilateral control of the debtor.

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<sup>18</sup> *Carlson v. Farmers Home Administration (In re Newcomb)*, 744 F.2d 621 (8th Cir. 1984).

<sup>19</sup> *Newcomb*, 744 F.2d at 624 (citing *Forest Hills Construction Co. v. City of Florissant*, 562 S.W.2d 322 (Mo. 1978)).

<sup>20</sup> *Newcomb*, 744 F.2d at 627, n.6.

<sup>21</sup> *Id.* at 627.

<sup>22</sup> *Cate v. Nicely (In re Knox Creations, Inc.)*, 656 F.2d 230 (6th Cir. 1981).

<sup>23</sup> *Intercontinental Publications, Inc. v. Perry (In re Intercontinental Publications, Inc.)*, 131 B.R. 544 (Bankr. D. Conn. 1991).

Other bankruptcy courts, applying New York law, have concluded that, "[t]he courts have uniformly held that the transfer of funds into escrow occurs at the time the debtor deposits the funds into the escrow account."<sup>24</sup> Neither the date the funds are released to the grantee nor the date the funds revert back to the grantor for failure of conditions precedent is relevant under section 547(b).<sup>25</sup> These cases are uniform in holding that it is the debtor's deposit of funds into escrow and not the award of judgment or subsequent release of the funds that is the controlling transfer for preference purposes.<sup>26</sup> The courts base their rulings on the ground that upon deposit of monies into escrow, the debtor reserves only a contingent right to those escrowed funds; a subsequent judgment or subsequent release of the monies does not deprive the estate of anything of value as the release of these monies is not a "transfer of an interest of the debtor."<sup>27</sup> Although a judgment or the release of the funds may very well constitute a transfer under the broad definition set out in section 101(54), it is not the type of transfer that can be avoided, for "[t]o be avoidable a transfer must deprive the debtor's estate of something of value which could otherwise be used to satisfy creditors."<sup>28</sup> Consistent with these holdings, courts have found that a transfer into an escrow account within the relevant preference period under section 547(b)(4) is an avoidable transfer.<sup>29</sup>

## V. Case Law in the Ninth Circuit

In the case of *In re Pelc*,<sup>30</sup> the bankruptcy court, applying Oregon law, stated that an escrow involves a two step process that consists of two deliveries:

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<sup>24</sup> Mitchell Shmon v. M & G. Promo Service Ltd. (*In re Anthony Sicari, Inc.*), 144 B.R. 656, 661 (Bankr. S.D.N.Y. 1992) (citing Pan American World Airways, Inc. v. Care Travel Co. Ltd. (*In re Pan Am Corp.*), 138 B.R. 382, 388 (Bankr. S.D.N.Y. 1992)).

<sup>25</sup> *Sicari*, 144 B.R. at 661.

<sup>26</sup> Hassett v. Blue Cross & Blue Shield (*In re OPM Leasing Servs., Inc.*), 46 B.R. 661, 668 (Bankr. S.D.N.Y. 1985), *aff'd in part and rev'd in part*, 48 B.R. 824 (S.D.N.Y. 1985); Sapir v. Eli Haddad Corp., (*In re Coco*), 67 B.R. 365, 369 (Bankr. S.D.N.Y. 1986); *accord In re Cedar Rapids Meats, Inc.*, 121 B.R. 562, 569-70 (Bankr. N.D. Iowa 1990).

<sup>27</sup> *OPM*, 46 B.R. at 668; *Coco*, 67 B.R. at 369.

<sup>28</sup> *Coco*, 67 B.R. at 369 (citing *Newcomb*, 744 F.2d at 626).

<sup>29</sup> Feltman v. Bd. of County Comm'rs of Metro. (*In re S.E.L. Maduro (Florida), Inc.*), 205 B.R. 987 (Bankr. S.D. Fla. 1997); Makoroff v. Roughen Investment Co., (*In re Allegheny Label, Inc.*), 128 B.R. 947 (Bankr. W.D. Pa. 1991).

<sup>30</sup> *In re Pelc*, 34 B.R. 823 (Bankr. D. Ore. 1983).

(1) to the depository, and (2) to the beneficiaries.<sup>31</sup> It found that the relevant transfer for preference litigation was when the debtors transferred into escrow the note, mortgage and satisfaction of mortgage, not the subsequent payment to the judgment creditors.<sup>32</sup> Its reasoning was based on the premise that the latter transaction did not involve a transfer of property of the debtors as the debtors' only remaining property rights were contained in the underlying escrow instructions which could not be modified absent consent on the part of both parties to the escrow.<sup>33</sup> As such, the transfer of monies to the judgment creditors no longer involved any property interest of the debtors.

In *In re Rehbein*,<sup>34</sup> the U.S. Bankruptcy Appellate Panel for the Ninth Circuit<sup>35</sup> discussed escrow accounts in dicta, finding that since a deed was placed in escrow prior to the commencement of bankruptcy proceedings, the Debtor had fully performed. The BAP stated that as a practical matter, the seller performs no duties after the execution and deposit of title documents with the escrow agent. The seller cannot terminate the agreement and recover possession of the property unless there is a material breach by the buyer.<sup>36</sup>

## **VI. Determination of When the "Transfer" Occurred: An Examination of Escrows Under California Law**

In the absence of bankruptcy precedent, the characteristics of an escrow must be examined under state law, as the extent of the debtor's property interest in the escrow is determined by state law.<sup>37</sup>

The applicable state statutory authority which involves the sale of personal property is found in California Civil Code section 1052 *et seq.*<sup>38</sup> "A transfer in

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<sup>31</sup> *Id.* at 826 (citations omitted).

<sup>32</sup> *Id.* at 826-27.

<sup>33</sup> *Id.*

<sup>34</sup> *Horton v. Rehbein*, (*In re Rehbein*). 60 B.R. 436, 440-41 (B.A.P. 9th Cir. 1986).

<sup>35</sup> The United States Bankruptcy Appellate Panel for the Ninth Circuit is hereafter referred to as the "BAP."

<sup>36</sup> *Rehbein* at 440-41 (citing *Newcomb*, 744 F.2d at 624).

<sup>37</sup> *Butner v. United States*, 440 U.S. 48, 55 (1979) ("The nature and extent of the debtor's interest in property is determined by applicable nonbankruptcy law.").

<sup>38</sup> CAL. CIV. CODE § 1052 (West 2006).

writing is called a grant, or conveyance, or bill of sale . . . .<sup>39</sup> "A grant takes effect, so as to vest the interest intended to be transferred, only upon its delivery by the grantor."<sup>40</sup> "A grant may be deposited by the grantor with a third person, to be delivered on performance of a condition, and, on delivery by the depository, it will take effect. While in the possession of the third person, and subject to condition, it is called an escrow."<sup>41</sup>

California law defines an "escrow" as:

[A]ny transaction in which one person, for the purpose of effecting the sale, transfer, encumbering, or leasing of real or personal property to another person, delivers any written instrument, money, evidence of title to real or personal property, or other thing of value to a third person to be held by that third person until the happening of a specified event or the performance of a prescribed condition, when it is then to be delivered by that third person to a grantee, grantor, promisee, promisor, obligee, obligor, bailee, bailor, or any agent or employee of the latter.<sup>42</sup>

A valid and binding contract must be entered into between the grantor and grantee in order to make an irrevocable deposit. The theory is that, if the grantor is bound, the grantee should likewise be bound.<sup>43</sup>

The true test is whether in parting with the possession of the conveyance, the grantor thereby intended to divest himself of title.<sup>44</sup> If so, there was an effective delivery of the deed.<sup>45</sup>

A deed handed to an escrow holder under binding instructions is validly delivered, and the grantor relinquishes all right to control or recall it, despite the fact that title does not pass to the grantee until the conditions have been met.

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<sup>39</sup> CAL. CIV. CODE § 1053.

<sup>40</sup> CAL. CIV. CODE § 1054.

<sup>41</sup> CAL. CIV. CODE § 1057.

<sup>42</sup> CAL. FIN. CODE § 17003(a).

<sup>43</sup> 12 B.E. WITKIN, SUMMARY OF CALIFORNIA LAW, REAL PROP. § 306 (10th ed. 2005).

<sup>44</sup> *Monterey Park Commercial Sav. Bank v. Bank of W. Hollywood*, 125 Cal. App. 402, 408 (1932). *But see Siple & Orrock v. Rechnitzer (In re M.B.K., Inc.)*, 92 B.R. 429 (Bankr. C.D. Cal. 1987) (transfer date of liquor license in escrow occurs when California Department of Alcoholic Beverage Control approves transfer of license).

<sup>45</sup> *Monterey Park* at 408.

performed.<sup>46</sup> An escrow holder is subject to the control of its principals, and it is the principals that issue the instructions to be followed by the escrow holder.<sup>47</sup>

Under California law, once there is a binding and enforceable escrow agreement between the parties, supported by adequate consideration, the deposit into escrow becomes irrevocable and neither party can withdraw its documents or money before the conditions to the closing of the escrow are satisfied (unless one of the parties defaults on their obligation under the escrow agreement).<sup>48</sup> As a result, the grantee acquires immediate equitable title to the subject property, and upon satisfaction or performance of the escrow conditions, legal title to the property passes to the grantee.<sup>49</sup>

However, where a buyer deposits money into escrow to be paid to the seller on close of escrow, the escrow holder is the buyer's agent as to such money pending close of escrow, and the buyer retains title to the money until the condition has been performed.<sup>50</sup> The money is only returnable to the buyer if the seller does not comply with the conditions.<sup>51</sup>

## VII. Conclusion

California law supports the conclusion that upon the creation of an escrow, equitable title to the property transfers to the buyer. Further, the escrow becomes irrevocable upon transfer of the documents or cash into escrow; the parties need not undertake any additional actions. As such, the transfer is perfected upon the parties' delivery into escrow. Once that has occurred, a lien creditor cannot obtain an interest superior to the transferee. Therefore, it is the delivery into escrow, not the subsequent release of funds out of escrow that determines the operative transfer date for preference litigation.

Parties confronted with escrow accounts should look to when delivery of property into escrow was effected in relation to the filing date of the bankruptcy

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<sup>46</sup> 12 WITKIN, *supra* note 43, § 308.

<sup>47</sup> Summit Fin'l. Holdings, Ltd. v. Cont'l Lawyers Title Company, 27 Cal. 4th 705, 711 (Cal. 2002), *cert. denied*, 537 U.S. 1001 (2002).

<sup>48</sup> Zeigler v. Hathaway Ranch P'ship (*In re Hathaway Ranch P'ship*), 127 B.R. 859, 863 (Bankr. C.D. Cal. 1990).

<sup>49</sup> *Id.*

<sup>50</sup> Kelly v. Steinberg, 148 Cal. App. 2d 211, 217-18 (1957).

<sup>51</sup> *Id.*

petition to determine if monies flowing into the account were made during the preference period under section 547(b)(4). As the case law and statutes indicate, it is this date that is relevant for determining a "transfer" for preference purposes, not when parties are paid from escrow. It is the deposit of the required documents into escrow, not the deposit of funds by a potential buyer, that is the operative "transfer" in connection with section 547.