Working with Escrow Agreements (with Form)

Earl L. Segal

Before drafting an escrow agreement, ask yourself the traditional "who, what, why, where, and how" questions.

THERE OFTEN COMES THE POINT in the course of a real estate transaction when the parties, though then on amicable terms, seek to have a disinterested third party act as a "stakeholder" or escrow agent. The purpose of the escrow agent is to help assure that whatever it holds will be applied, distributed, or otherwise dealt with as contemplated by the parties, free of interference or other influence from any of the parties who have established the escrow. In analyzing the arrangement necessary for a successful escrow, consider the ingredients to a successful news story, namely, who, what, why, where, and how. This article and the appended specimen escrow agreement analyze escrow arrangements by considering these basic questions.

WHO? • The parties to a transaction will typically use an escrow agent when they want a disinterested, trustworthy third party to hold something valuable for them. In real estate transactions, the third party might be a title company, a bank, an individual, perhaps one of the lawyers or brokers involved in the transaction, or possibly, even if not initially, a court.

Ability

If the escrow agreement contemplates multiple disbursements or significant actions by the escrow agent, there may be parties who are more suited for the performance of these actions than others. For example, a title company may agree to act as an escrow agent on a temporary basis; however, it might not, without additional consideration paid to it, wish to be involved in multiple disbursements, complicated investment requirements, or other similar acts that would be considered to be outside of the scope of what normally would be deemed to be an accommodation to the parties.

Impartiality and Potential Conflicts of Interest

When selecting the appropriate party to be the escrow agent, consider not only the impartiality of the party, but also the party's ability and inclination to fulfill its obligations as contemplated by the applicable documentation.

For example, if the lawyer for one of the parties involved is to act as the escrow agent, the escrow agreement should reflect the fact that the lawyer is acting in a capacity separate and apart from that of the lawyer to one of the parties. If a dispute should arise under the escrow agreement, the lawyer may want to continue representing one of the parties in the underlying transaction. The agreement must therefore clearly define the role that the lawyer may perform with regard to the lawyer's ethical responsibilities. For example, instructions to the escrow agent, acting in its capacity as escrow agent, should not be subject to the attorney-client privilege, and, if a dispute develops, it should be a condition precedent to the lawyer continuing to act as counsel for one of the parties, that the lawyer resign as escrow agent. Also, the lawyer may wish to have the parties confirm that the fact that it has acted as the escrow agent will not, in and of itself, disqualify the lawyer from representing one of the parties. In some jurisdictions the lawyer considering acting as an escrow agent may not be able to "

draft around" the ethical issues raised by such actions and may be well advised to decline serving as both lawyer and escrow agent in the transaction.

Liability for Expired Letter of Credit

An expired letter of credit is worthless; therefore, if a letter of credit is posted to secure the payment of a deposit or other monetary sum, consider the ability of the escrow agent to discharge any liability stemming from its failure to present a letter of credit for payment before the letter of credit's expiration.

Similar issues relating to letters of credit also arise in connection with typical provisions in escrow agreements that permit the escrow agent, in the event of a dispute, to deliver the letter of credit to a court of applicable jurisdiction for disposition by that the court, thereby relieving the escrow agent of any liability for the letter of credit. In such a circumstance, the beneficiary of the escrow has more than a little right to feel uncomfortable that the court, acting as it deems best, and perhaps not strictly in accordance with the terms of the escrow agreement, may let the letter of credit expire without presenting it for payment, notwithstanding the terms of the escrow agreement that typically require the escrow agent to cash a letter of credit before its expiration.

In all events, if the escrow agent is the lawyer for one of the parties, a title company, a real estate broker, or some other party involved in the transaction, the escrow agreement should be clear that with respect to the obligations of the escrow agent, it is acting in strict accordance with the terms of the escrow agreement, notwithstanding any other relationship that may exist between the parties.

WHAT? • Money is probably the most common commodity held by an escrow agent in a real estate transaction, however, as noted above, the escrow agent may also be required to hold a letter of credit, or possibly securities. If money is held, consider whether the money is to be kept in an interest-bearing or non-interest-bearing account, and, if in an interest-bearing account, whether the interest or other earnings that accrue on the escrowed amount are to be deemed part of the escrowed amount or paid over to one of the parties, either as the interest is paid to the escrow agent, or perhaps at the completion of the escrow. If securities are held, consider whether the party placing the securities in escrow is required to maintain a certain dollar value of escrowed securities.

An obligation to maintain a certain value of escrowed securities cuts both ways: not only is there the possibility that, if the securities drop in value below a specified level, the party responsible for depositing the securities must deposit additional securities with the escrow agent to bring the escrow up to the required level, but the parties should deal with the possibility that the securities might appreciate in value, and if the party who deposited the securities is entitled to a return of a portion of the escrow so the value of the escrow is brought down to a predetermined level.

There is a potential for difficulties in managing these accounts, which are adjusted to the securities markets. These difficulties arise out of the risk that if the securities increase in value and shares are returned to one of the parties, the party who has received the return of a portion of the previously posted escrow will not honor its obligation to restore the value of the escrow to the pre-agreed upon level if the value of the escrow subsequently drops.

Whether the escrow is in the form of securities or cash, the escrow agent should require the parties to complete the forms and take any other actions that may be necessary for the escrow agent to comply with its obligations and the law. For example, the parties should complete W-9 forms with

taxpayer identification numbers so interest on any cash escrow may be appropriately reported. Further, appropriately executed blank stock powers should be tendered to the escrow agent so, if it is obligated or otherwise empowered to sell stock it is holding in escrow, it may do so.

As previously noted, if a letter of credit is held by an escrow agent, it is extremely important that the escrow agreement provide, in clear terms, that if the letter of credit is about to expire and has not been replaced with either cash or other pre-agreed upon substitute collateral, the escrow agent will, without further direction or instruction from any of the parties, cash the letter of credit, and hold and invest the cash it receives as the escrow.

WHY? • Reasons for holding security in escrow are limited only by the imagination of the parties. The more typical reasons include such matters as:

- Security deposits under leases;
- Deposits under contracts of sale;
- Damage deposits under development agreements;
- Matters in dispute at real estate closings; and
- Sums to be held pending the outcome of protests, appeals, or other disputes.

The purpose of an escrow is to help assure that, at the time determined for the distribution of funds or other escrowed items to any party, the items are available for distribution in the manner and at the time originally contemplated by the parties.

WHERE? • If the escrow consists of cash, it may be held in certificates of deposit, interest-bearing accounts, and a variety of other investments. The form escrow agreement that accompanies this article provides a number of possible investment types. When selecting the investment, it is important to make sure that the maturity of the investment matches the requirements for distribution under the escrow agreement. Although a better yield might be obtained on a one-year certificate of deposit, if closing under a real estate contract is to be held within six months and the escrowed amount will be required at that time, it probably would not be prudent to lock up the investment past the time when the deposit is anticipated to be required.

Consistent with the general philosophy that escrow agents usually prefer to act simply as " stakeholders," and not be required to exercise independent judgment or take discretionary acts, an escrow agent should seek to have the parties release it for any loss, of principal or otherwise, that occurs in connection with the escrowed amount, if the escrowed amount has been invested in accordance with the instructions of the parties.

HOW? • Depending on the entity chosen to act as an escrow agent, the parties might anticipate some differences in the standards and requirements of the escrow agent. For example, if a bank is used, the bank may very well have its own form of escrow agreement and charge a fee. Further, the bank may wish to make it very clear to the parties that, not only does the bank not have any liability for its actions under the escrow agreement (with the possible exception of its willful malfeasance—and good luck proving it), but also that the parties jointly and severally indemnify and hold the escrow agent harmless from all actions, as well as any liabilities that it may incur as a result of its performance of its duties as escrow agent. There might also be the joint and several obligation of the parties to reimburse the escrow agent for any costs it may incur (including attorneys' fees, even those incurred by the

escrow agent for simply consulting with its attorney whenever it feels this is appropriate). Additionally, a bank, in its capacity as escrow agent, may very well wish to provide that its accounts are satisfactory investments for the escrowed amount.

Title companies, or their agencies, may be a little less strict in their requirements. Still, requiring the escrow agent to take discretionary actions probably is not in the best interest of any of the parties, including the escrow agent. A well-advised escrow agent will also provide in the agreement that, if it is entitled to reimbursement, indemnification, or payment of any sum, and if that sum isn't promptly paid to escrow agent, the escrow agent may take its payment from the body of the escrow.

CONCLUSION • The specimen escrow agreement accompanying this article contains many of the provisions discussed in the preceding portions of this article, and, in part, also addresses items that were not included, but are otherwise self-explanatory. Although the accompanying form has been structured for a cash deposit to be held under a purchase and sale agreement, it is easily modified for other transactions. The reader will note that nowhere in the document (except perhaps in the recitals when completed) is there a reference to the underlying agreement of sale. This approach is consistent with the philosophy that the escrow agreement should stand on its own and not require the escrow agent to review, interpret, or otherwise consider the underlying document. Although you need to give care to matters relevant to the establishment of an escrow arrangement, with a little thought, effecting the mutual goals of the parties is a readily achievable goal.**Appendix**

Escrow Agreement

THIS ESCROW AGREEMENT (this "Agreement"), is made as of the ___ day of _____, _____ by, between and among _____, a _____ _____ (the "Escrow Agent"); _____, a _____ _____ (the "Seller"); and _____, a _____ _____ (the "Purchaser").

RECITALS

[RECITAL ONE]

[RECITAL TWO]

[RECITAL THREE]

[RECITAL FOUR]

NOW, THEREFORE, in consideration of the foregoing recitals, each of which is made a part of this Agreement, and for other good and valuable consideration, the receipt and sufficiency of which the parties to this Agreement acknowledge and, intending to be legally bound, the parties to this Agreement do hereby agree as follows:

1. *Establishment of Escrow*. The Purchaser tenders to and deposits with the Escrow Agent the sum of _____ Dollars ($_____) (the "Escrowed Amount") to be held and applied by the Escrow Agent solely in accordance with and subject to the terms of this Agreement. The Escrowed Amount shall include all interest earned on the Escrowed Amount, the dividends paid with respect to