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The Seller Against the Secured Creditor of the Purchaser

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Here is a column I wrote for the American College of Real Estate Attorneys on a California case pitting the seller against a secured creditor of the purchaser over undistributed escrow funds. Other articles may be found at RogerBerhnardt.com

Oxford St. Props., LLC v. Rehabilitation Assocs., LLC (2012) 206 CA4th 296, 310, 141, CR3d 704

In a recent California decision, *Oxford St. Props., LLC v Rehabilitation Assocs., LLC* (2012) 206 CA4th 296, 310, 141 CR3d 704, a loan was made by Citibank to enable Rehab to buy out Oxford, its real estate partner. Citibank took as security for the loan a recorded deed of trust on the partnership real property and a filed security interest in all accounts and deposit accounts in which the partnership *"now has or may hereafter have an interest ... relating to ...* [*the*] *property."*. Most of the loan funds were disbursed to Oxford, except that $700,000 was held back in escrow to deal with some remaining matters.

Rehab defaulted on both its purchase and its loan obligations. Oxford obtained a money judgment against it (through arbitration), and Citibank conducted a trustee sale of the real estate. Since both creditors recovered less than they were owed, each sought to reach the funds still in the escrow. Oxford prevailed, which may or may not have been fair to those parties, but which, in any event, can be instructive to sellers and lenders in other transactions.

The Seller's Claim

Oxford's claim to the undisbursed escrow funds was based on the arbitrator's ruling that those funds belonged to it as part of the purchase price it was to receive under its sales contract with Rehab, even though that sale had been ultimately rescinded for Rehab's bad acts, and even though these funds had been loaned to the Rehab-Oxford partnership rather than directly to Oxford. The money was in escrow but Oxford had obtained a writ of possession to get to it, which supported its claim to those funds.

Was Oxford's entitlement defeated because the money had come from Citibank, passed through Rehab, and was now in the possession of an escrow agent? This was a holdback escrow, in which the seller's title had passed to the buyer before all of the funds were received by the seller, leaving unresolved the status of the funds that were still there. In a holdback escrow, the ordinary rule that the money belongs to the buyer before close and to the seller after close does not normally apply, bus since Oxford probably would have been held to be the one to suffer if the escrow agent had absconded with the funds (see *Bixby Ranch Co. v U.S.* (1996) 35 Fed Cl 674, 681), the court upheld the arbitrator's conclusion that the money already belonged to it.

Oxford's claim to the funds was therefore a good one, and so sellers in such situations need not change their strategy in order to gain more protection. Setting up an escrow in which the price is to be deposited and instructing the escrow agent not to deliver the deed to the purchaser until all of the money is there is enough to protect a seller's claims to that money, as against all rival claims or risks (except, of course, the risk of the escrow agent running off with the money after escrow closed).

The Lender's Claims

The funds in escrow could be the seller's property yet nevertheless subject to a lender's prior secured claim. Citibank's deed of trust and security agreement were surely recorded and filed before its loan funds left its vaults for transfer into the escrow. Could that put it ahead of Oxford, even if title to the funds would ultimately pass to Oxford?

It's unclear from this opinion whether Citibank lost because its debtor Rehab had no interest in those funds, or because its security agreement failed to give it a proper security interest in those funds. Both explanations were offered in the opinion, which makes it hard to advise future lenders what steps they need to correct if they want to avoid suffering the same fate that befell Citibank.

Rights in the Collateral

Commercial Code §9203(b)(2) provides that a security interest does not attach to collateral unless the debtor has "rights" in it. If the funds in the holdback escrow were not the property of Rehab because they belonged to Oxford, then Citibank could get no security interest in them no matter what the documents said. The arbitrator's conclusion that the seller was entitled to the loan funds also meant that the buyer had no rights in them, thereby defeating any claim to a security interest in them by the buyer's secured creditor. Once escrow closed - even if it included undisbursed funds - those funds would belong entirely to the seller.

If Citibank lost because Rehab had no rights in the escrow funds, there was not much it could have done to improve its situation. Its deed of trust gave it a valid lien on the real estate that Rehab was acquiring with the loan funds, but its security agreement could not also give it a valid security interest on those same funds. If Citibank wanted more security than just the real estate it was financing, it could not do so by claiming a security interest in the very funds it was loaning to its borrower.

No Attachment

The court's opinion also seems to hold that the language of the security agreement was not good enough to give Citibank a valid interest in the escrowed funds. The security agreement had created a security interest in all accounts and deposit accounts in which the partnership "now has or may hereafter have an interest ... relating to ... [the] property." That, according to Citibank, included the funds in the escrow, but the court said that that was not what the provision meant.

That conclusion is from saying Rehab had no rights in the collateral, since it only declares Citibank guilty of bad drafting (although the language of the provision does look pretty broad), which is a shortcoming that can be corrected in future loan documents. Absence of rights on the collateral, on the other hand, cannot be helped by improved language. Which explanation is correct dictates which strategy to pursue in the future.

No Perfection?

A third explanation hinted at in the opinion was that Citibank had not properly perfected a security interest in the loan funds. If this escrow account qualified as a deposit account (at another institution), it required perfection by "control," and not by simply filing a UCC-1 statement. See Com C §§9104, 9312(b)(1). If that was Citibank's (only) mistake, it was a secured but unperfected creditor, rather an unsecured creditor under the two previous scenarios.

If Citibank was an unperfected secured creditor, then it was in a priority fight with Oxford, the outcome of which might depend on the status assigned to Oxford. Oxford might contend that instead of being an owner, it was rather a lien creditor - and one who had levied on the collateral before Citibank had perfected in it (see Com C §9317)!