

CLIENT UPDATE



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With over 25 years of experience dealing with a broad spectrum of business law issues, Ed has developed expertise in the areas of Business Aviation and Aircraft Finance. Ed provides value-added counseling and advice to clients on a variety of business aviation issues, including: purchase and sales, structuring of ownership and operations, state and federal tax planning, regulatory compliance, financing and risk management. Ed is the Vice Chairman of the National Business Aviation Association Tax Committee, the Chairman of the Associate Member Council of the National Aircraft Resale Association and an active member of the National Aviation Finance Association and the Rhode Island and Massachusetts Business Aviation Associations.

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NEW CONSIDERATIONS FOR AIRCRAFT DEPOSIT AND ESCROW ACCOUNTS IN TIMES OF ECONOMIC CRISIS: CONTINGENCY PLANNING FOR THE UNTHINKABLE

Security deposit and escrow accounts are widely used in aircraft acquisitions, sales and day-to-day transactions. New aircraft buyers make security and earnest money deposits and progress payments to be held by a manufacturer. Purchasers and sellers of new and used aircraft use title and escrow services in Oklahoma City for initial deposits and disbursement of the purchase price of an aircraft. Tax free exchange companies retain large sums of money equal to the purchase or sale price of an aircraft for periods of one hundred eighty days or longer. Aircraft management companies control significant sums of money in "operating accounts." Program maintenance providers handle maintenance reserves based on hours flown as contingencies against future scheduled and unscheduled maintenance events. Financial institutions often require cash security deposits in connection with aircraft financings. These are just a few of the ways in which an aircraft owner may have large sums of money held by a third party.

Historically speaking, having money held in these types of accounts was safe and relatively risk free. Industry norms and practices were commonly observed and funds flowed freely and efficiently through the accounts with few losses occurring. The banks and other financial institutions in which these funds were held were considered safe, solvent and reliable. However, in the current world economic crisis aircraft owners and prospective aircraft owners should reexamine some of the practices surrounding the placement and utilization of security deposit and escrow accounts.

This article cannot address all of the types of accounts and the considerations for each. However, it will suggest some questions that you should ask and propose some solutions that are common to many different escrow and deposit account relationships.

Many security deposit accounts and escrowed funds are held in large accounts and co-mingled with depositor's funds from other transactions. This is a practice that should be scrutinized on a number of levels. First, when you give your security deposit or escrow funds to a stakeholder, do you even know the identity of the institution that is holding the funds? Oftentimes, the depositor only knows the identity of the party to whom it has given the funds, for instance, the title/escrow company in connection with a closing. The depositor may have no idea who is actually holding the funds, in what investment vehicle the funds are being held or whether the funds are being held in a separate or co-mingled account.

Recent events have shown just how dangerous these practices can be. In late 2008, a large real estate title insurance company became insolvent

and filed for bankruptcy protection. A related 1031 Like Kind Exchange Company was caught up in the bankruptcy filing of the parent title company. Funds held in escrow by the Exchange Company for its customers were frozen. Unfortunately, large portions of the escrowed funds were held in obligations backed back by a large, but insolvent, Investment Bank. The Investment Bank collapsed at roughly the same time as the Exchange Company filed for bankruptcy protection. Needless to say, many customers of the Exchange Company lost their money and their contemplated exchanges failed.

How could the customers have avoided this unfortunate outcome? First, let's look at what these customers did correctly. The customer's escrowed funds were held in separate accounts. These accounts were in the name of the customer rather than the Exchange Company.

Best Practice Tip: Insist on having your funds held in a separate account segregated from other depositor's funds. This will make it easier for you to identify and recover your funds in a bankruptcy or liquidation proceeding against either the stakeholder, in this case the Exchange Company, or the institution in which the funds were invested, the Investment Bank. Most reputable stakeholders will agree to set up a separate, segregated account in your name. Maintaining a separate account also permits the depositor to more closely monitor the account balance, deposits and distributions into and out of the account and the performance of the deposited funds. It will also make it easier to receive meaningful periodic accountings related to the deposited funds.

While it may have seemed like a good choice at the time, investing escrowed funds in obligations of the Investment Bank turned out to be a very imprudent decision. Customers should have a choice as to *how* their funds are invested, but you may not have a choice as to *where* the funds are invested. For example, many escrow agents maintain relationships with only one depository institution.

Best Practice Tip: You should ask where your funds will be deposited or invested and make inquiries into the solvency of that institution. If you are not comfortable with where your funds will be held, you should take your business elsewhere. If you do have a choice, you may have a choice of investment vehicles with various rates of return. Generally speaking, the higher the yield, the greater the risk. However, the reward of a higher yield may be outweighed by the risk. The Investment Bank obligations in the example cited are reported to have paid only 25 to 50 basis points more than an FDIC insured account! As it turned out, there was a very steep price to pay for a very small increase in the rate of return.

Not all deposit accounts are created equal. The type of deposit account, where the account is maintained and by whom can make a significant difference in the rights that you have to the proceeds of such accounts. An extremely important criterion for selecting both a depository institution and the investment vehicle is Federal Deposit Insurance Corporation insurance. Generally speaking, funds held at banks and similar institutions are protected by FDIC guarantees up to \$250,000. However, certain investment vehicles at FDIC insured institutions, such as certain types of money market mutual funds, may not be FDIC insured. Funds held by non-banks and funds invested in commercial paper or other higher yielding investment vehicles are not FDIC insured. Given the short term nature of many deposit and escrow accounts, the relatively higher yield on non-FDIC insured investments is probably not worth the risk.

Best Practice Tip: Consider the trade off between higher yield and safety. Assuming the safety of your funds is an important factor, insist that your funds are held at an FDIC insured institution. Make sure that your funds are placed in investment vehicles that are afforded full FDIC insurance protection.

What about deposit and escrow accounts in excess of \$250,000? The good news is that FDIC insurance limits have recently been raised from \$100,000 to \$250,000. The new, higher \$250,000 FDIC insurance limit, in effect through 2009 and perhaps beyond, will protect many escrow and security deposit accounts. However, it is not uncommon for security deposit accounts related to aircraft purchases to exceed \$250,000. Depending upon the type of aircraft, management company operating accounts and accounts held by maintenance providers may well be larger than \$250,000. Accounts used to disburse purchase proceeds for new and used aircraft sales and 1031 exchange accounts routinely surpass \$250,000.

Fortunately, there are some types of accounts that are not subject to the \$250,000 FDIC insurance limit. The FDIC recently announced a Temporary Liquidity Guarantee Program which expanded FDIC protection for “non-interest bearing transaction accounts” even if the balance in the account exceeds \$250,000. In order to qualify, the funds must be held at an FDIC insured institution and invested in a non-interest bearing transaction account. Interest on Lawyer Trustee Accounts (“IOLTAs”) maintained by lawyers or law firms are also exempt from the \$250,000 FDIC insurance limitation. Non-interest bearing transaction accounts and IOLTAs are useful alternatives for larger deposit and escrow accounts. The reader is cautioned that these exemptions are due to expire at the end of 2009 and financial institutions have the ability to “opt out” of coverage. Some additional due diligence is required to confirm that you are setting up a qualifying account at a bank which participates in the expanded FDIC coverage program.

Best Practice Tip: Larger deposit and escrow balances require additional scrutiny and diligence. Sacrifice yield and opt for safety and security. To preserve FDIC guarantee protection, maintain funds in excess of \$250,000 in (i) non-interest bearing transaction accounts or (ii) a lawyer’s IOLTA account.

Note that it may be possible to obtain FDIC protec-

tion for funds held in co-mingled accounts if the depositor is able to demonstrate the source and amount of funds. For example, Purchaser sends \$200,000 to Escrow Agent as a security deposit in connection with the purchase of an aircraft from Buyer. Escrow Agent deposits the \$200,000 with Bank pending completion of the purchase transaction. Purchaser’s funds are placed in an account in the name of Escrow Agent at Bank in which funds totaling \$1,000,000 from several other sources are held. If Bank fails, Purchaser’s funds will still be protected by the FDIC if Purchaser and Escrow Agent can prove that the funds were sourced from and held for the account of Purchaser. While it may be possible to demonstrate that \$200,000 of the co-mingled account balance is held on behalf of Purchaser, Purchaser’s path to the recovery of its funds from a co-mingled account will no doubt be more cumbersome than if the funds were held in a separate account in its own name.

Purchase and sale transactions for used aircraft typically utilize escrow services for the transfer of funds and documents. In the past, many of these transactions have proceeded without written escrow agreements. Many times the escrow agent will merely countersign the Purchase and Sale Agreement acknowledging their obligations thereunder. Many times there will be no written understanding at all with respect to the terms and conditions of the release of funds and documents. With more prospective deals than ever not making it to a successful closing, this is a dangerous and uncertain way to proceed. The time to negotiate the terms and conditions of release or return of escrowed funds is not after the deal is going sideways!

Best Practice Tip: Have the terms and conditions governing the holding and distribution of escrowed funds and documents set out in writing and signed by each of the depositor, the beneficiary of the funds and the escrow agent. Carefully review the terms and conditions under which escrowed funds are held. Make sure that the written agreement spells out where funds and documents will be held, in whose name the account will be maintained and under what circumstances the funds and documents can and will be released and to whom.

Finally, consider the solvency and financial health of all parties to the transaction. In addition to concerns about the financial well being of the institution holding your escrowed funds, have you considered the possibility of financial difficulties or bankruptcy of the other parties to the escrow or deposit relationship? What would happen if the escrow agent became insolvent or another party to the transaction filed for bankruptcy protection? Having carefully drafted documents addressing these concerns in advance can avert a great deal of uncertainty and difficulty if any of the parties to the transaction have financial problems.

In conclusion, in these uncertain financial times it is now more important than ever to pay close attention to how deposited and escrowed funds are held. Careful advance planning of how and by whom funds are held and proper documentation of the deposit or escrow relationship is critical. Such planning can preserve your rights to the funds and avoid a significant amount of confusion and trouble if and when the current economic crisis impacts your transaction or relationship.

If you have any additional questions regarding this Update or have any other Corporate & Business needs, please contact any member of the Group.

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