BANKRUPTCY
AND
TITLE INSURANCE

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INTRODUCTION

Bankruptcy is undoubtedly one of the most intricate specialties in the practice of law. It has its own rules, practices and procedures that often conflict with the traditional training of a real property specialist. Fortunately, the real property specialist does not require expertise in the methods and processes of bankruptcy in order to handle a real property transaction in which a bankruptcy is involved.

The transactional lawyer is interested more in the results of a bankruptcy than in the subtleties of bankruptcy practice. This course is intended to aid the real property practitioner in closing a real property transaction so that the resulting title will not be affected by the bankruptcy of one of the participants. It is not intended to prepare you for representing a client in a bankruptcy proceeding.

We will view bankruptcies from three perspectives:

1. Current Bankruptcies: Cases pending against one or more of the parties to a current real property transaction.

2. Concluded Bankruptcies: Closed cases affecting either a party to the current real property transaction or one appearing in the back chain of title. When do you have to review a closed proceeding?

3. Anticipated Bankruptcies: What will be the effect upon title if a participant in the current transaction subsequently goes into bankruptcy? The "Creditor's Rights" problem.

I. PENDING PROCEEDINGS

A. Automatic Stay [362(a)]

The single most significant aspect of the entire bankruptcy process is the automatic stay. Its intricacies are most complex, and it truly is the heart of all bankruptcy practice, but for our purposes it simply means creditors are prohibited from enforcing obligations against the debtor.

It applies to every kind of obligation the debtor may have. To all entities. To all property of the estate. To all types of enforcement, administrative as well as judicial.

1. Restraints on the Debtor

The stay under Sec. 362 is not directed at the debtor, and does not restrict the debtor at all; however, something like it arises under other provisions of the Code.

Upon filing a petition in bankruptcy an "estate" is created under Sec. 541. This "estate" consists of all interests the debtor may have in any property, including joint tenancies and tenancies by the entireties. Sec. 363 then specifies how a trustee may dispose of property of the estate, and Sec. 1107 extends the powers of a trustee to a debtor in possession.

Accordingly, for real property transaction purposes, you will treat the debtor as stayed from transferring property or encumbering property just as effectively as the creditor is stayed from taking property away from him until you can demonstrate of record freedom from this restraint in a manner discussed below.

B. Relief from Stay

1. Exempt Property [522]

a. Homestead

The Code allows an exemption for specific amounts of particular kinds of property or permits a state to set its own limits. North Carolina has opted for this election; therefore, the federal bankruptcy exemption is limited to, "The debtor's aggregate interest, not to exceed ten thousand dollars ($10,000) in value, in real property or personal property that the debtor or a dependant of the debtor uses as a residence…." NC General Statutes §1C-1601.

b. Claiming the Exemption

The key to bankruptcy homestead is claiming it in the bankruptcy proceedings. It must be claimed on the schedules accompanying the petition that commences the bankruptcy or an amendment thereto. If you don't claim it, you don't get it, even if you in fact are entitled to it. If you claim it and technically it does not qualify, if it is not contested, or successfully contested, you do get it. (There are sanctions against claiming an exemption fraudulently.)

c. Contesting the Exemption

Once the exemption is claimed on the Schedule attached to the petition a meeting of creditors will be held within 20 to 40 days after the petition is filed. [Rule 2003] Different periods apply for Chapters 12 and 13. Objections to the claimed exemption must be filed within 30 days of the first meeting of creditors. [Rule 4003] If no objection is filed, the exemption will stand and may not thereafter be attacked. [Taylor v. Freeland & Kronz, 112 S.CT. 1644] If the exemption is contested, the court must hold a hearing and decide the issue.

d. Effect of Exemption

Essentially, the homestead, once exempted, is no longer "property of the estate". The debtor can sell or mortgage it; however, it is subject to all of the liens and encumbrances that existed before, and the creditors are still stayed from enforcing their claims, the property is still protected by the constitutional provisions regarding homestead; but <u>liens are not removed by the mere claiming of the exemption</u>!

The Bankruptcy Code provisions dealing with a discharge only apply to debts, not liens. Thus title to property that comes out of the bankruptcy because it is exempt as homestead is still clouded by the potential for a pre-existing judgment to attach as a lien if the property ceases to be the debtor's homestead, even though the pre-existing judgment was "discharged" in the bankruptcy.

The solution is in Section 522(f). Section 522(f) allows the bankruptcy court to enter an Order to "avoid" any "judicial" lien that "impairs an exemption". This order should routinely be obtained in any bankruptcy involving exempt property and judgment liens; however, it is available even long after the bankruptcy is closed. It may be reopened and the new order entered in an abbreviated proceeding without even the necessity for notice to the former creditors.

e. Other Exempt Property

In addition to the homestead, Section 522(b)(2)(B) allows an exemption for property the debtor owns in an estate by the entireties, even though it is not the homestead. This has led to conflicting decisions on the extent to which joint creditors of both husband and wife may cause this exemption to be nullified, even as to creditors of only one of them. The real property practitioner will only rely upon the exemption if it is claimed in Schedule C, is not contested within 30 days after the first meeting of creditors, or any contest is not sustained and the appeal period expires.

2. Ordinary Business [363(c)(1), 721, 1107, 1108]

If the debtor is in the business of selling real property, i.e., a developer, then a trustee in bankruptcy or debtor in possession under Chapter 11 may continue to operate that business and sell land.

Under Sec. 363(c) no further orders are necessary to enter into specific transactions "in the ordinary course of business"; however, there will always be a blanket order authorizing the trustee, or debtor in possession, to continue to operate the debtor's business. The enabling order will set parameters for sales, minimum prices, limits on quantities, terms, etc. with requirements for further approvals if beyond those parameters.

3. Sales Free and Clear [363(f)]

There may be circumstances in which the equity in a parcel would provide valuable cash to a debtor's estate, but the mortgagee refuses to release his lien because he wants the benefit of the appreciated or enhanced value of the land.

This provision, expressly upon order of the court, allows the trustee to sell free of the recorded liens and allows the court to apply the proceeds to the secured creditors and the excess to other debts of the estate.

The important point here is the order. It must expressly direct the sale "free and clear" of liens, and must expressly detail the allowed expenses of sale that the closer may pay out of the proceeds.

CAUTION: Often orders look like 363(f) orders, are even entitled "Free and Clear", but buried in the later provisions are requirements for one or more secured creditors to be paid out of the proceeds and to satisfy their liens. Read them carefully. Such orders would not automatically extinguish liens. You should require estoppel letters and even escrow the satisfactions or releases if the order is so drafted.

This section of the Code may also be used to sell free of other interests in the property such as joint tenants, and even tenancies by the entireties under certain circumstances. For our purposes the essential element is the order expressly stating the sale is to be free of such interest and of course the adverse interest holder must have been served with notice of the hearing and given an opportunity to respond.

4. New Mortgages or Deeds of Trust [364(c)&(d)]

Under this section the court may authorize creating a new debt secured by equity exceeding other secured debt, or even grant priority over other inferior liens. This requires an express order, but when properly approved it can be relied upon to create a new mortgage superior to existing liens.

5. Executory Contracts [365]

Pending contracts such as leases (landlord debtor or tenant debtor), sales contracts and agreements for deed not yet paid in full, options not yet exercised, must be assumed (accepted or confirmed) by the trustee within 60 days after the petition (anytime before the plan in Chapters 9, 11, 12 or 13) otherwise they are deemed rejected.

Although this section provides for automatic rejection, there invariably will be an order rejecting the executory contract which you may rely upon if the holder of that interest was properly noticed and given an opportunity to respond.

6. Foreclosure

The automatic stay [362(a)] is most frequently applied to avoid foreclosure of a mortgage. The stay prevents filing a foreclosure suit or pursuing an existing one. Once the petition is filed in bankruptcy, the mortgagee may only proceed upon entry of an order lifting the stay for this express purpose.

Again a note of caution, read it carefully. A not uncommon practice is to lift the stay to allow the mortgagee to proceed through the final judgment, but not sale. This permits one more review of the possible equity of the debtor. A separate order is then required to authorize the sale and certificate of title.

7. Appeals

a. Computing the Period

In bankruptcy, Rule 8002(a) allows ten days following an order for filing a notice of appeal. Under Rule 9006(a) you omit the day of the order, but count the last day. Weekends and holidays are counted unless the last day falls on a day the Clerk's office is closed (for whatever reason, including inclement weather).

b. Ignoring Appeal Period

You may be requested to proceed within the ten days following an order prior to expiration of the appeal period. This is unique to bankruptcy practice, never in state or other federal proceedings, and arises in either of two circumstances.

(1) Hearing Unnecessary

Under Section 102(1)(B) when the Code requires "after notice and a hearing", a hearing is not in fact required if proper notice is given but no one requests a hearing. In that event the trustee may proceed with the proposed action even though no hearing was held; however, it does not obviate the necessity for an order if an order is needed.

It may arise under Sec. 363(b) when a trustee proposes to sell a parcel, but will pay off and furnish satisfactions or releases from all secured creditors. In that event only an unsecured party might likely want a hearing to contest the sales price or expenses of sale. If a hearing is not requested you may safely close when the date passes stated in the motion upon proof (certificate from counsel, the trustee or Clerk) that a hearing was not requested within the period.

If an order is necessary to lift a lien, i.e., to sell free and clear, or to grant a special priority over other liens, this procedure is still applicable, but an appeal right arises upon entry of the order.

(2) Mootness Doctrine [363(m)]

Section 363(m) provides a subsequent reversal on appeal will not affect a sale or lease by the trustee to one who purchases in good faith "whether or not such entity knew of the appeal, unless such authorization and such sale or lease were stayed pending appeal". A most noted case on this issue occurred in Miami involving the Theodore Gould bankruptcy and sustained this practice in Miami Center v. Bank of New York, 838 F2d 1547.

CAUTION: This procedure only applies to court ordered sales or leases, not to approval of plans.

II. CONCLUDED PROCEEDINGS

One of the unique features of bankruptcy is its continuing effect even after it is concluded. The stay continues to prevent enforcement of liens in many instances. The effect of the court's orders will continue. Depending upon what you are relying upon the bankruptcy for, you may or may not have to examine prior proceedings against current or former parties to the chain of title.

A common standard is to disregard bankruptcies finalized more than seven years earlier. In truth you can't set an arbitrary period. If you find the necessary orders from the bankruptcy in the Official Records, and the bankruptcy is no longer open, you should be able to rely upon the recorded orders without reviewing the bankruptcy file even if it is only a couple of years old.

If the necessary orders are not of record you will have to review the file, and often a bankruptcy order is not complete without the motion seeking it.

Following is a review of how bankruptcy cases are concluded and their effect on title.

A. Dismissal

This occurs when the bankruptcy does not go through to final fruition. In Chapters 12 and 13 the debtor may dismiss voluntarily at anytime. In Chapter 11, and to a lesser extent Chapter 7, upon motion by a creditor the court may find the proceedings not in good faith and direct their dismissal. An involuntary proceeding could similarly be dismissed on showing that relief is not warranted. Under Chapters 7 and 11 an express order of dismissal is required. Unilateral notice filed by the debtor in Chapters 12 and 13 will suffice. In either event a dismissal effectively revokes the stay and all limitations on the debtor and the creditor are removed.

B. Plan of Reorganization

Represents the successful rehabilitation of the debtor under Chapter 11. All that has been said about pending proceedings is applicable here. The Plan may include provisions for transferring assets, eliminating or reducing liens, establishing special priorities for new mortgages.

If the plan affects interests in real property it should be recorded. If you are attempting to close and the seller/borrower insists an objection to title was resolved by the Plan, but it is not of record, you will have to examine it and place it of record if it does.

Plans are only operative if confirmed by order of the court. Once confirmed and the appeal period is expired, it would normally not be necessary to review the entire proceedings. The plan itself will show the parties served with notice. If the holder of the matter you are attempting to eliminate was adequately notified of the proposed plan and did not object or appeal, you may safely rely upon it.

Section 1146(c) provides deeds and mortgages issued pursuant a confirmed plan are exempt from state documentary stamp taxes, and this has been recognized by the Florida Dept. of Revenue in Administrative Rule 12B-4.014(16).

C. Discharge

Arises on approval of the Plan or upon liquidation and distribution of assets. In the simple Chapter 13 it may be a one page pre-printed order. In the major commercial or institutional case it may be hundreds of pages and continue for years.

The essential for title purposes is to remember it does not discharge liens, it discharges debts. You will have to look for specific orders to transfer assets or eliminate liens. The discharge merely says everything that needed to be done was done and nothing else remains. You have to locate and record the specific order you need.

1. Effect of Discharge

a. Discharges debts, not liens. [524(a)]

b. Continues stay, except as modified.

c. 522(f) order to remove judicial liens from homestead.

d. Non-dischargeable debts - Fraud, child support, etc. - unaffected.

e. Statutes of limitations - Not tolled; but, extended for 30 days following lifting of stay. [108(c)]

III. ANTICIPATED

What effect will a future bankruptcy by one of the parties have on the transaction you are attempting to close?

Our main problem is in getting all the facts. Knowing what the transaction is really all about. Who the parties are and their relation to one another. The consequences are apparent if the facts are adequately understood.

A. Preference [547]

Allows a trustee to avoid or set aside a conveyance or mortgage that occurs within 90 days prior to the filing of a petition in bankruptcy, one year if to an insider, that goes to or for the benefit of a creditor who holds an antecedent (existing) debt, if the debtor is then insolvent (or becomes insolvent by the transaction), and the result is to enhance the position of the creditor.

1. Transfer - Any conveyance or mortgage.

2. To a creditor, or for the benefit of a creditor. A deed in lieu of foreclosure. A modification or refinance of a mortgage. Sales at arms length, new mortgages to

new lenders, even to pay off old loans to different lenders are not subject to this concern. Be alert to a deed to an entity related to an existing mortgagee. Most commercial deeds in lieu go to subsidiaries of the lender.

3. Antecedent debt - A debt that already exists as distinguished from a new debt being created. A second mortgage for new money actually disbursed isn't a problem. Any mortgage securing an existing debt or modification to add new land or old debt is a problem.

4. While insolvent - A very complex determination, involving data normally not available to the person handling a real property transaction; however, if the other criteria are present, you should assume they are insolvent. You don't want to close preference transactions merely upon the assurance that they are not insolvent.

5. Within 90 days, one year for insiders. Likewise, insiders are difficult to determine, but you would normally not want to close a preference transaction, insider or not.

6. Improves creditor's position - Modifications that only extend the due date or reduce the interest rate do not improve the creditor's position. The technical language is "enables such creditor to receive more than such creditor would receive ..." if it was a Chapter 7, the transfer hadn't occurred, and the payments made were per the Code. Basically you are looking for new security for the debt. Is this for the debtor's benefit or the creditor's?

Additionally you must "consider" the potential for a creditor's rights problem in every modification of mortgage and in every new mortgage to an existing creditor. If the modification adds new land or cross collateralizes or cross-defaults, these are giving the lender something he would not otherwise have had.

A future advance under a valid future advance clause does not improve the creditor's position. A second mortgage or increase without a future advance, to the extent it represents new money actually disbursed, is not a problem. It is given for "new value". An increase to "capitalize" interest does create a problem. It would be secured by the old mortgage, but the interest that will now be accrued on the old interest is giving a new advantage to the creditor.

If the modification does not increase the security it is okay. If it only increases the debt by new money, it is okay. If it adds previously unsecured debt to the mortgage it is subject to attack.

Most transactions are routine sales and mortgages for present value. What you are looking for is the transfer to a creditor or the modification of a mortgage that gives the mortgagee something it didn't have before.

B. Fraudulent Transfers [548 and NC Gen. Stat. §39-23.1]

Actual fraud usually is readily apparent. A deed shortly before a judgment was recorded. Transfers to related parties. Gifts. Virtually any transfer not pursuant to a regular contract of sale should be questioned.

The one you want to look for is the transfer for "less than reasonably equivalent value". Under the Code the trustee may set aside such transfers within one year of the filing for bankruptcy. Under the North Carolina version of the Uniform Fraudulent Transfers Act it is four years. It doesn't have to be to a creditor, but often is. The principal cases have involved leveraged buy-outs, securitizations and guaranties.

You will now be primarily concerned with commercial transactions. Residential transactions for less than reasonably equivalent value will be obvious. Deeds in lieu are the primary problem. Our former concern over the Durrett Rule is now resolved. Regularly conducted foreclosure sales will not cause concern even when for a nominal bid, but the deed in lieu of foreclosure universally carries this risk.

1. Leveraged Buyouts

The proceeds of a mortgage by a corporation or partnership are disbursed to "buy out" the stock or interests of the former stockholders or partners. They do not go for the benefit of the corporation or partnership itself. You must question every commercial financing transaction. If the proceeds are not going to pay off corporate debts, red flags should go up. Even where the disbursement is back to the borrower, you have an obligation to inquire into what it will be used for. If you are not disbursing to pay off a mortgage, get a full explanation of the transaction in writing.

2. Securitizations

One person may be the general partner of several limited partnerships or the principal investor in several corporations. He proposes to consolidate all of their outstanding loans in a single blanket mortgage. This means partnership #1, that had a debt of $100,000, is now pledging its assets to secure a $1,000,000 debt with nine others. If it works it is great. If not, and partnership #7 fails to pay its share, the property of partnership #1 will get foreclosed out along with all the others.

This raises the question of the authority of the general partner to pledge the assets of partnership #1 for the debts of the other nine entities. A general partner probably does not have this inherent power. It would require the consent of all other partners.

It also is clearly for "less than reasonably equivalent value", so that even with express authorization from all the other limited partners, it is still subject to attack by creditors of the partnership.

3. Guaranties

When a subsidiary pledges its assets for the debt of its parent (upstream guarantee), the subsidiary clearly does not get the money. It goes, or went previously, to the parent. So in guaranteeing the debt of a sister corporation (side stream) the mortgagor does not get the benefit. Its sister corporation does. Both of these are subject to attack just as a mortgage by one person for the debt of another. This doesn't mean the transaction fails. It is only subject to attack in a bankruptcy by creditors that were prejudiced.

Downstream guaranties, parent guaranteeing the debt of a subsidiary, are treated as acceptable since the parent owns all of the stock of the subsidiary; however, since the consideration is not going directly to the mortgagor, it could give rise to a recharacterization problem discussed below.

4. Lease Terminations

If a tenant in a shopping center voluntarily surrenders the lease so the developer can remodel and expand, and then enters into a lease of space in the new structure, at a greatly increased rent, the surrender of the old lease may be found to be for "less than reasonably equivalent value".

5. Subordination/Recharacterization

In the most publicized case of recharacterization, United States v. Gleneagles, 565 F. Supp. 556, proceeds of mortgages from subsidiaries went to the parent, but the parent used them, with the knowledge of the lender, to pay off stockholders selling shares in the parent. While embodying the aspects of a leveraged buyout, the bankruptcy court subordinated the lender's mortgage to the rights of other creditors and treated it as a fraudulent conveyance.

C. Title Insurance Considerations

The ALTA policies of title insurance dated 1992, and as modified for use in Florida, all contain a pre-printed "Exclusion From Coverage" on the inside of the cover excluding liability for preferential transfers and fraudulent transfers.

The language adopted in 1992 has been approved by all government entities and major lenders. The 1990 language was expressly rejected by many and is not approved in Florida.

The exclusion has two potential pitfalls for the real property practitioner issuing title insurance. First, it is limited to attacks upon the current transaction, i.e., "arising out of the transaction vesting in the insured the estate or interest insured by this policy". It does not exclude attacks upon any prior transaction.

Second, most modifications of mortgages being handled currently were insured by pre 1992 policy forms that did not contain such exclusion.

Accordingly, before endorsing a title policy to insure the effect of a new modification, make certain what form was used, and obtain the underwriter's position on the effect it may have.