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BANKRUPTCY AND THE TRANSFER OF REAL ESTATE



An Overview of the Federal Bankruptcy System and its
Interaction with the Transfer of Real Estate

Presenters

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Bankruptcy – What is it?

- “A system designed to give honest debtors an opportunity to start over by discharging their debts...while providing for the orderly liquidation or reorganization of the debtor’s estate.”
Local Loan v. Hunt, 292 U.S. 234
- Its own Code, Rules, Courts. In NC, Eastern, Middle and Western Districts with Divisions within each District, geographically.
- Insolvency is a condition that may drive debtors into bankruptcy. *Symptom v. Cure.*



The Bankruptcy Estate

- When a debtor, whether an individual, spouses or a business entity, files for protection under the bankruptcy court, the court prescribes which assets are to be used in order to pay creditors all or some of what they are owed.
- In some instances, there may be disagreement over which assets are included. In such cases, the bankruptcy court will hear arguments and issue a court order detailing its decision(s).

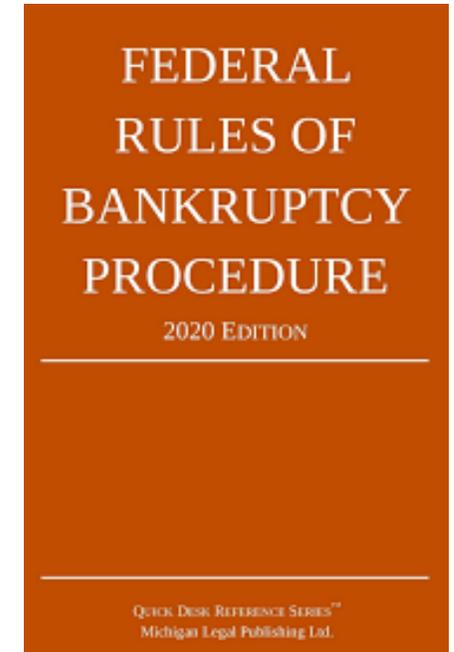
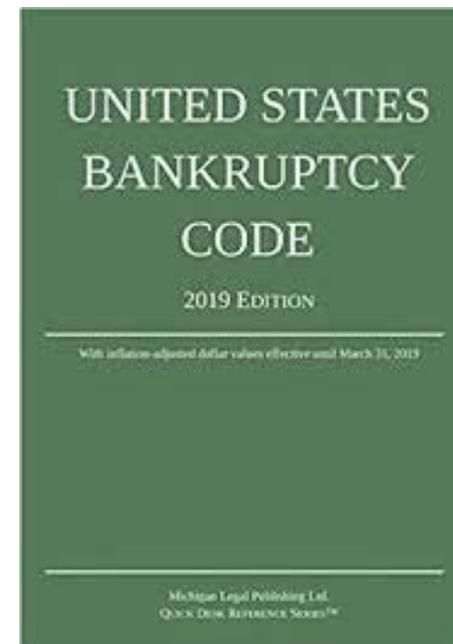
- All legal and equitable interests the debtor has in property/assets on the day the petition of bankruptcy is filed, with some specific post petition interests included.
- LESS interests in property **exempted** by the individual debtor. **11 U.S.C. §522**
- Retirement Accounts
- ITEMS REMOVED FROM ESTATE:
 - Sold in accordance with Bankruptcy Code
 - Abandoned by Trustee under court order or confirmed plan
 - Foreclosed upon under Order to Lift Stay
 - ALL property remaining in estate if Court DISMISSES case.



The Code

11 U.S.C. Title 11

- Chapters 1 – 5 – Administrative/General
 - Chp. 5 most important
 - Exemptions, Taxes, Estate, etc.
- Chapters 7, 11, 12 and 13
 - Chp. 7: Liquidation of Assets
 - Chp. 11: Business Debt Reorganization
 - Chp. 12: Family Farm/Fish
 - Chp. 13: Wage Earner Individual (non-business)



The Rules

Federal Rules of Bankruptcy Procedure

Technical Procedures that are enforced across all courts/states.
Critical for Bankruptcy Practitioners but important for Real Estate Practitioners.

- Who requires notice and how it is given.
- Appeals.
- Conversion to Chapter 7.
- Adversarial proceedings.



Local Rules

All Districts of the Bankruptcy Court have Local Rules for the efficient administration of cases and adversarial proceedings, based upon their unique:

- Structure
- Judges
- Clerk's Office/Rules

NC Districts:

Eastern

Middle

Western



Divisions – geographically placed courts within the Districts



Core Concepts for the Real Estate Practitioner



- **Property of the Estate** – When a bankruptcy is filed, the assets of the debtor become the “estate” controlled by the court. It consists of “All legal or equitable interests of the debtor in property as of the commencement of the case”. 11 U.S.C. §541(a)(1). There are exceptions to this general rule. For real estate, the main exceptions are: Debtor Exemptions and Avoidable Transfers.
- **Avoidable Transfers:** These can increase the size of the estate by either bringing assets back into the estate or avoiding a secured interest on assets.
 - **Preferential Transfer:** A transfer by debtor (1) to or for a creditor; (2) for debt owed prior to filing; (3) while debtor was insolvent; (4) made within 90 days of filing, or one year if to an insider; AND (5) so that creditor got more than a Chapter 7 payment.
 - **Fraudulent Transfer:** A transfer by debtor within 2 years if the court determines that there is actual intent to hinder, delay or defraud; OR, that the asset was sold for less than reasonable value; AND, Debtor was insolvent or became insolvent because of transfer.
 - **Self Settled Trust:** Within 10 years IF made by Debtor, who is a beneficiary, with intent to defraud.



- **Exemptions** – Statutorily defined amounts of equity that the debtor may claim against property in the estate. Federal code allows the use of state exemptions. North Carolina exemptions are found in NCGS 1c-16. For real estate, each debtor is allowed up to \$35k against their residence. A married couple would have \$70k total. A surviving tenant by the entirety has a \$60k exemption against equity in the property.
- **Plan** – Under chapters 11 and 13, the debtor, as Debtor in Possession, create a feasible plan that will provide payments to creditors of at least what they would receive under a Chapter 7 liquidation. The plan must be confirmed by court order. The plan should be specific about how real estate will be handled.



- **Automatic Stay** – Under 11 U.S.C. §362(a), the filing of a petition triggers an automatic stay as to any collections, including legal action, by the creditors. There are limited exceptions, notably the perfecting of mechanics liens. Creditors may not move forward until the stay is lifted by court order, dismissal of the case or discharge of the case (for liens that attach to property).
- **Discharge Order** – The release of debtor from personal liability for pre-petition debts. It does not conclude the case and it does not release liens that attach to property, without specifically stating the same.
 - Chapter 7 – Discharge order after all assets distributed.
 - Chapter 11 – Upon confirmation of plan. Confirmed plan acts as substitute contracts with creditors.
 - Chapter 13 – Discharge after successful completion of plan, which must contain a release of liens if appropriate.



- **Dismissal Order** – Dismissal of a bankruptcy case means that the debtor’s case has come to an end without successful completion of the bankruptcy, either because of the failure of the debtor to fulfill requirements or by request of debtor. An order is necessary to dismiss. Issues may arise in Chapter 13 cases if property has been sold “free and clear of liens” prior to the dismissal of the case. Often, instead of dismissal, a Chapter 11 or 13 debtor will convert the bankruptcy to a Chapter 7 liquidation.
- **Chapter 11 “In the Ordinary Course of Business”** - Under Chapter 11, the debtor carries on the business as a “Debtor in Possession”. As DIP, the debtor has statutory authority to sell assets, including real estate, “in the ordinary course of business” if it is part of how the business is conducted. The classic example is a home builder, who may sell homes that are being completed. Most times, it is not so straight forward. A court order confirming that a sale is “in the ordinary course of business” is always preferable.



Types of Bankruptcy

Bankruptcy types are defined by the chapter of the Code in which their relevant and unique provisions are found.

In order addressed herein:

- Chapter 7
- Chapter 11
- Chapter 13



Chapter 7 Liquidation of Debtor's Assets 11 U.S.C. §§ 701 – 784

Trustee Signs Deed

“Tom Trustee, Trustee of the
Bankruptcy Estate of Danny Debtor,
Case No. _____, U.S. Bankruptcy Court
for the Western District of North
Carolina”

- Individuals and Entities may file
- Trustee owns assets
- Trustee signs deed out of bankruptcy
- Stay automatic
- Secured Creditors can get stay lifted, especially if little or no equity
- Trustee may abandon property and/or “sell” equity to debtor or lender
- Discharge Order after all assets disposed of
- Dismissal Order if debtor fails to fulfill requirements/obligations
- “No Asset” Chapter 7 case means no assets to distribute to unsecured creditors. Secured Lenders can still foreclose after Lift Stay Order



Chapter 7

Orders Typically Seen

- **Order Authorizing Trustee to Sell:**

- Specific as to what real estate
- Who was noticed
- Which liens will be paid, if any
- Specific order

- **Order on Motion to Lift Stay:**

- Who was noticed?
- Must be an order to FORECLOSE
- If equity in property or exemptions, the court will sometimes give only an order to obtain an ORDER TO FORECLOSE FROM LOCAL STATE JURISDICTION. The lender's counsel will then have to go back to court to obtain the order to foreclose.

- **Order Abandoning Property or Dismissing Bankruptcy:**

- These orders would put the secured creditor and the debtor in the same positions they were before the bankruptcy and the secured lender could then foreclose without an order lifting the automatic stay.



Chapter 11 Reorganization of Business Debts

11 U.S.C. §§ 1101 - 1195

Debtor in Possession Signs Deed (Unless Court Order appointing Trustee)

“Penny President, president of Debtor Co., Debtor in Possession under Bankruptcy Case No. ____, U.S. Bankruptcy Court for the Eastern District of North Carolina”

- Most complex – counsel should be involved
- Business – entities or individuals with more than 50% of debt related to business
- Debtor in Possession (DIP)
- DIP can be removed for incompetence, fraud, dishonesty, etc.
- Plan must be confirmed
- Confirmed plan acts as substitute contract with creditors
- Discharge upon confirmation of plan
- DIP can sell property “in ordinary course of business”
- Secured creditors may seek Lift Stay if plan not followed
- DIP has authority of trustee to avoid liens, abandon property, sell property – in confirmed plan OR court order.



Chapter 11

Subchapter V

Small Business Debtors

11 U.S.C. §§ 1181 - 1195

Enacted in 2019. Effective 2/19/2020

For business debtors with up to \$2.7mm+ in secured and unsecured debt. Raised to \$7.5mm under CARES Act temporarily. (The CARES Act expires in March of 2021, unless extended.)

- Debtor required to file plan within 90 days.
- Debtor is Debtor in Possession, but if plan is confirmed without approval of creditors, Trustee collects and distributes all payments.
- Creditors must get at least as much as they would in a Chapter 7 liquidation.
- **Secured Creditors:** (1) Retain full security in property even while getting paid under plan; and, (2) Retain right to obtain Lift Stay upon failure of payments. These allow a secured creditor to capitalize on any deficiencies in security especially if increase in value of property.



Chapter 11

Single Asset Real Estate Debtors

Single Asset Real Estate: A single property or project that generates all of the gross income of the debtor and which no substantial business is being conducted by debtor other than the business of operating the real property and activities incidental. 11 U.S.C. §101(51B).

- Secured Lender friendly.
- Debtor's plan must show a reasonable certainty that it can begin making payments to creditor within 90 days, at least equal to the non-default interest rate on the secured interest.
- Court will grant Lift Stay orders routinely if and when debtor fails to make the payments.



Chapter 11

Orders Typically Seen

- **Order Authorizing DIP to Sell:**

- Specific as to what real estate
- Who was noticed
- Which liens will be paid, if any
- Specific order

- **Order on Motion to Lift Stay:**

- Who was noticed?
- Must be an order to FORECLOSE
- If equity in property or exemptions, the court will sometimes give only an order to obtain an ORDER TO FORECLOSE FROM LOCAL STATE JURISDICTION. The lender's counsel will then have to go back to court to obtain the order to foreclose.

- **Order Abandoning Property or Dismissing Bankruptcy:**

- These orders would put the secured creditor and the debtor in the same positions they were before the bankruptcy and the secured lender could then foreclose without an order lifting the automatic stay.



Chapter 13
Wage Earner's
Debt Adjustment
11 U.S.C. §§ 1301 - 1330

Requires Court Order to Sell

DIP signs deed: "Danny Debtor, Debtor in Possession in Bankruptcy Case No. _____, U.S. Bankruptcy Court for the Middle District of North Carolina"



Chapter 13

Wage Earner's Debt Adjustment

- Wage earning individuals only.
- Designed to allow individuals and spouses to readjust and retain assets.
- Most often filed to prevent or forestall foreclosure on residence.
- Automatic Stay in effect for duration of plan.
- Not true Debtor in Possession – Trustee receives and disburses all payments.
- Debtor makes up delinquent payment through plan while making regular payments to secured creditors.
- Debtor required to obtain confirmation of feasible plan.
- Must obtain court order to sell property.
- Discharge upon successful completion of Plan, not at confirmation of plan. Requires “Final Discharge/Release of Liens” upon successful completion of plan for Lien Avoidance of judgment liens on property. TITLE TRAP...address with counsel.
- Very high failure rate – often converted to Chapter 7 Liquidation.
- Can be complex. Counsel should be involved.



Chapter 13

Orders Typically Seen

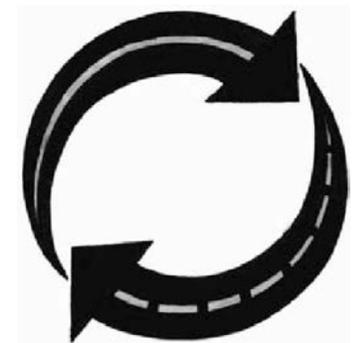
- **Order Confirming Plan:**
 - Same as Chapter 11 for real estate purposes (variations, but not affecting real estate significantly).
- **Order on Motion to Lift Stay:**
 - Would allow lender to foreclose if delinquent payments missed.
- **Order Discharging Debtor:**
 - Comes at end of plan (3-5 years if not extended to 7).
 - Would/should include the order releasing any liens that were avoided under prior orders.
- **Order to Avoid Liens or Sell Free and Clear:**
 - These **need special counsel approval** because the debts are not discharged when the Plan is confirmed. And, Chapter 13 requires that any liens avoided be finally released upon completion of the plan/discharge.



Recurring Issues in the Transfer of Real Estate

Any number of issues may arise.

The ones seen most frequently . . .



Bankruptcy in the Chain of Title



- Liens:
 - Debtor is generally released from personal liability for debts, including liens that attach to real estate.
 - Unless there is an Order directing otherwise, the liens – mortgages, judgment liens, taxes, etc. – remain against the real estate and must be paid off or otherwise released upon sale of the real estate.
- Proper party signing deed:
 - Was there a Court Certified Order recorded with the transaction directing the Trustee or the Debtor in Possession to sell the property?
 - Was the deed signed by that party in the appropriate manner (see above under each Chapter)?
- Foreclosure:
 - Was a Lift Stay Order obtained by lender?
 - Did lender take any actions to collect debt or foreclose during pendency of bankruptcy?



Notice of Bankruptcy

- How do you know if a seller is in bankruptcy?
 - Could be filed in any state in the country.
 - Most attorneys do not check PACER as part of their preliminary title search.
 - Seller or seller's attorney should provide the information with the contract.
 - Contract should be signed by Trustee or by Debtor in Possession (and acknowledged as such).
 - PACER is the federal government's case tracking system and can be invaluable. There is no cost to establish an account and very reasonable terms, most often free for occasional use.
- NCGS 47-29: A copy of the bankruptcy petition...**shall** be recorded with the register of deeds. By who? Statute doesn't say. IF notice is filed, it is almost exclusively filed by the Trustee. It gives notice to anyone with an interest or potential interest in the property.



Chapter 13 Plan Issues



- Very high failure rate – leads to dismissal or conversion to Chapter 7.
- Plans often state that upon completion, liens upon property are released. **MUST** have 2nd discharge – Final Decree – in order to accomplish this.
- Insuring a sale with a plan in process is very difficult.



Liens NOT made part of the estate

- Liens not listed by debtor or noticed by trustee/Debtor in Possession before Discharge Order.
- Deeds of trust, judgment, taxes.
- In most cases, personal obligation released, but lien still attaches. Even though not noticed, creditor may not move forward with collection without an order lifting the automatic stay. Failure to do so – during the pendency of the bankruptcy – violates the automatic stay even without notice.



Real Estate NOT brought into estate

- It happens – sometimes inadvertently, other times on purpose.
- To sell, property will need to be brought into estate, even if the case has to be re-opened.
- Trustee/Debtor in Possession can then obtain order to sell, abandon or otherwise dispose of it.
- Otherwise, trustee may treat as an avoidable transfer and move the court for an order finding the same and, in some cases, to invalidate the transfer.



- While Section 362(a) of the Code prohibits collection efforts by creditors (“Automatic Stay”), Section 362(b)(3) DOES allow perfection of liens if state law imposes such a lien prior to perfection.
- In NC, a mechanics’ lien attaches at the date of first furnishing of work, even though not perfected until a claim of lien is filed. NCGS Sections 44A-10 and 44A-18.
- If the first furnishing is prior to the filing of bankruptcy, the mechanic/creditor may continue to perfect its lien by filing claim of lien so that the lien attaches to the real property.

Mechanics’ Liens vs Automatic Stay



Bankruptcy Appeals Periods

- Any party may file an appeal within 14 days of the entry of a judgment, order or decree of the Bankruptcy Court.
- If filed prior to entry (after announcement of finding but not yet entered), deemed to have been filed on day of entry.
- Any other party may file within 14 days of initial appeal – must be checked.
- If there are any questions about appeals in your transaction, consult with title counsel.

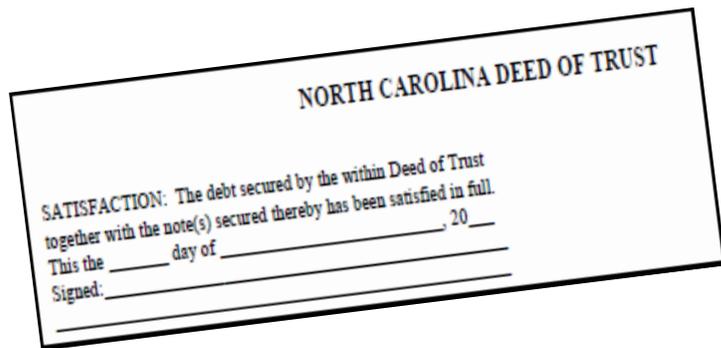


- General Rule – exempt.
- Specific Rule – Debtor must have a “confirmed plan” prior to transfer of property for excise taxes to be exempt.
- Definitive Supreme Court case – ***Florida Department of Revenue v. Piccadilly Cafeterias, Inc. (2008)***.
- The case centers around the fact that the government (i.e. Trustee in Bankruptcy) would be exempt. While a Debtor in Possession takes on Trustee responsibilities, a DIP is nonetheless not an instrumentality of the U.S.
- SO, Plan MUST be confirmed by court prior to transfer of property for excise taxes to be exempt in Chapter 11 cases.

Excise Taxes in Chapter 11 Cases



Uncancelled Deeds of Trust when Bankruptcy Order or Confirmed Plan Requires Release



- If Bankruptcy is still open – petition the court to compel the Secured Creditor to comply with terms of the Order or Plan.
- If Post-Bankruptcy/sold by Trustee or Debtor in Possession – it may be necessary to re-open Bankruptcy to compel compliance by Secured Lender.
- If Debtor/Bankruptcy in chain of title, it may not be feasible to re-open case. Some alternatives:
 - Provide evidence of compliance with Order/Plan re: payment to Secured Creditor.
 - Contact Secured Creditor with Order/Plan and obtain release.
 - Follow procedures set forth in NCGS §45-36.13 et seq. for release by Satisfaction Agent.



- A Discharge in bankruptcy is when the court determines that the debtor no longer has personal liability to the creditors. It comes at different times under the Chapters as set forth in the discussions above.
- A Dismissal is when the court “calls off” the bankruptcy case, putting the debtor and the creditors back in the same positions they were prior to filing.
- An alternative to dismissal of a Chapter 11 or Chapter 13 would be a conversion to a Chapter 7 liquidation case – which the debtor may do once by right.

Discharge VS Dismissal of Case



Liens Addressed in Prior Bankruptcy

- You may find a bankruptcy in the chain of title in conjunction with judgments and other liens that attached prior to the filing of the bankruptcy petition.
- The default position is that they attach to the property even though the debtor's personal liability may have been relieved.
- Either the trustee or the Debtor in Possession may move the court to sell "free and clear" of such judgments and liens, but there must be an Order specifically relieving the property of such judgments and liens – and the Order MUST be recorded.



Single Member LLC as Asset in Personal Bankruptcy - Prior Bankruptcy

- Debtor files for bankruptcy. Debtor has one or more LLCs set up to hold title to real estate.
- Debtor is sole member of LLC(s).
- The LLC may be a single asset entity or hold multiple parcels of real estate and/or other assets.
- The LLC itself is an asset of the bankruptcy estate and Trustee or Debtor in Possession is the “owner” of the LLC.
- There MUST be an order allowing the sole member LLC to sell the real estate, as the Trustee or Debtor in Possession have control over the LLC itself.
- ISSUE: How do you know that the sole member is in bankruptcy?



ORDERS, ORDERS, ORDERS

- Every action taken by the bankruptcy court must be done by Order, with the possible exception of being done within a Chapter 11 or 13 Plan – which still needs to be confirmed by Order.
- Orders recorded in the land records are essential to the integrity of the chain of title.
- Orders must be read carefully for proper notice and the exact, specific findings of the court – which are often at odds with what the seller believes.
- Orders to be recorded must be Bankruptcy Clerk Certified Copies, recorded as separate documents.
- **ORDERS ARE YOUR BEST FRIEND.**



Insuring out of Bankruptcy

- When insuring out of bankruptcy, there are several factors to consider:
 - Is there an Order authorizing the sale?
 - Is there an Order stripping judgments or otherwise directing a “free and clear” sale?
 - If there is a “free and clear” order, which liens specifically are being removed?
 - If a Chapter 11 “ordinary course of business” sale:
 - Has the Plan been confirmed by the Court? (Order)
 - Has the Sale been approved by the Court? (Order)
 - Is the transfer a very crystal-clear “ordinary course of business” transaction?
- If out of foreclosure, has a lift stay order been entered with the Court?
- For all Orders, do they sufficiently describe who was served with notice, how they were served, and if it was sufficient notice?



Brief Checklists for Chapters 7 and 11

- CHAPTER 7:
 - Record Order directing Trustee to sell property, abandon property or exempting property.
 - Record Deed executed properly by Trustee.
 - Order to sell free and clear of liens (if appropriate), being specific as to notices and which exact liens shall not apply to the property.
 - Final Discharge of Debtor and closing of case (if sold post-bankruptcy).
- Chapter 11:
 - Confirmed Plan.
 - Record Order for Debtor in Possession to sell Property.
 - Record Order for selling free and clear of liens, if appropriate.
 - Record Plan if no Orders – usually prompts an order because debtors do not want plan recorded.
 - Order of Discharge.
 - Record Deed properly executed by Debtor in Possession.



Brief Checklists for Chapters 13 and Post-Bankruptcy Transfers

- CHAPTER 13:
 - Confirmed Plan.
 - Record Order to sell property by Debtor in Possession.
 - First Order of Discharge AND Final Decree of Discharge at successful conclusion of Plan.
 - Record Order to sell free and clear of liens (if appropriate).
 - Record Deed properly executed by Debtor in Possession.
- Sale After Bankruptcy:
 - Record Order of Discharge/Final Decree.
 - Record Order for Abandonment, Exemption, etc., showing a return of the property to Debtor, if appropriate.
 - Record Order for selling free and clear of liens, if appropriate.
 - Pay off/release of liens not extinguished as against the property by bankruptcy.



Brief Checklist for Foreclosures During Bankruptcy

- FORECLOSURE:
 - Order to Lift Stay allowing lender to foreclose, verifying full authority to foreclose and not just to obtain judgment to foreclose (which could be the case for partial exemptions or significant equity in the property).
 - Determine that foreclosure notices and actions were in accord with bankruptcy law and state statutes in terms of reconstituting a foreclosure instituted prior to the filing of bankruptcy petition by debtor.
 - Proper service/notice of foreclosure under state statutes.
 - Adherence to foreclosure requirements for title insurance.





On the Lighter Side



Thanks for joining us.

Please submit your questions or comments to:

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Visit us at www.northcarolina.ctic.com.