Bankruptcy Overview

The filing of a petition commences a bankruptcy case. Once a bankruptcy petition is filed, a bankruptcy estate is created, and an automatic stay, which prohibits any action to collect debts of the debtor, becomes effective. Throughout a bankruptcy, the assets of the estate will be collected. The bankruptcy estate may be supplemented through the trustee's avoiding powers. Once collected, the real property will be distributed out of the bankruptcy estate through abandonment (§554); Exemption (§522) Sale (§363) or Confirmation of the Plan (in Chapter 11 or 13). Finally, if the debtor completes bankruptcy, they will receive a discharge. A discharge only discharges the personal liability of the debtor. Property subject to a lien before bankruptcy remains subject to the lien following the discharge. Liens ride through bankruptcy. The only exception is when there is a specific order removing the lien.

Property of the Estate Considerations

Upon the filing of a bankruptcy, property is divided into the following two categories: 1. property of the estate in bankruptcy; and, 2. property of the debtor. The distinction becomes especially important when analyzing the effects of the stay. It also becomes important when analyzing the ability to sell pursuant to 11 USC 363. Section 363 authorizes a sale by the estate, it does not apply to property of the debtor.

The filing of a petition in bankruptcy, whether voluntary or involuntary, creates an estate in bankruptcy, under section 541 of the Bankruptcy Code. All of the property within the bankruptcy estate is subject to the automatic stay provisions of 11 USC 362. The bankruptcy estate consists of the debtor's entire legal and equitable property interests, wherever situated and by whomever held, that existed as of the commencement of the case, (which is time that the bankruptcy petition was filed). In addition, property of the estate includes many property interests acquired by the debtor after the commencement of the case, for example by a bequest, devise, or inheritance to the debtor within 180 days after the filing. It also includes property, if any, recovered for the estate after the filing by the trustee. The property of the estate in bankruptcy is subject to use, sale, or lease under section 363 of the Bankruptcy Code.

Property of the debtor is property acquired by the debtor after the commencement of the case, which would not constitute property of the estate, for example - exempt property (11USC 522), property abandoned to the debtor (11 USC 554), property re-vested in the debtor upon confirmation of the plan of reorganization (11 USC 1129 & 1141 or 1325 & 1327), and property that does not become a part of the estate such as the

debtor’s beneficial interest in a spendthrift trust.

Abandonment

A title insurance underwriter will have to determine whether insured property is property of the bankruptcy estate. Earlier, we briefly discussed the creation of the estate upon bankruptcy case commencement and characterized the administration of the bankruptcy proceeding as the process of disposing of estate property. Whether property remains or is no longer property of the estate directly impacts the requirements for the transfer of the interest insured. Done improperly, a title defect (and possible claim) is created, requiring you to either pass on a transaction or require curative action before you insure. For example, if the deed transferring property is from the debtor, but at the time of the transfer the property was property of the estate, title to the property was not transferred and a title defect was created. The trustee, not the debtor, held title to the property. Abandonment is one of the mechanisms through which property is removed from the estate, as part of the administration of the bankruptcy proceeding. Abandonment occurs either by motion under 11 USC §554(a) and (b) or by operation of law under 11 USC §554(c). Usually abandonment is only applicable in a chapter 7 bankruptcy since a chapter 13 plan confirmation re-vest property in the debtor. Under §554(a) and (b) the trustee may abandon, or a party in interest may request the trustee to abandon, after notice and a hearing, any property of the estate that is either burdensome to the estate or of inconsequential value and benefit to the estate. Under §554(c) scheduled but unadministered property of the estate is abandoned to the debtor upon case closure. Unscheduled and unadministered property of the estate remains property of the estate (unless the court orders otherwise). If a property remains property of the estate

after case closure, the bankruptcy proceeding must be reopened, and the property must be scheduled and administered or abandoned.

The Automatic Stay

The Bankruptcy Code provides for an automatic stay upon the filing of a bankruptcy petition under any chapter of the Bankruptcy Code. The stay is provided for under 11 USC 362. The stay is extremely broad in effect and stays virtually all formal or informal actions taken against the debtor or property of the estate, subject only to the exceptions to the stay contained in 11 USC 362 (b). It extends to all acts to collect prepetition claims and all actions that would affect property of the estate. 11 USC 362 (a) (5) makes the stay applicable to any act to create, perfect, or enforce against ***property of the debtor*** any lien to the extent such lien secures a claim that arose before the commencement of the case. It also stays any attempts to obtain possession of property of the estate or of property in the custody of the estate. It should be noted that the stay enjoins all ***entities.*** Entity is a defined term under 11 USC 101, and is broader in scope than the term person; entity includes person (individual, corporation, and partnership), estate, trust, governmental unit, and the United States trustee.

Actions that violate the stay are void. This causes major title concerns that must be cured before the issuance of a policy. Do not insure acts that are, or may be, in violation of the Automatic Stay. Do not ignore a lien or other interest simply because it was recorded after commencement of bankruptcy. To insure without exception to a lien recorded after the filing of a bankruptcy, you should either obtain an order cancelling the lien as a violation of the automatic stay, or obtain a satisfaction, cancellation and release of the lien from the lienholder.

Automatic Stay issues arise often in title insurance underwriting. Foreclosures, and other actions to enforce security interests in the debtor's pre-petition property, frequently trigger the filing of the bankruptcy petition. The creditor's subjective good faith in proceeding with the foreclosure (due to lack of notice or actual knowledge of the bankruptcy filing) does not cure the defect.

The stay, although broad and extensive, is not absolute, and exceptions to the stay are set forth in 11 USC 362 (b). Exceptions to the stay notwithstanding, the debtor may always seek an injunction under section 105 of the Code where warranted even as to matters excepted from the stay. The bankruptcy courts have traditionally been granted ample authority, under section 105, to enjoin actions excepted from the automatic stay when the actions would interfere with the rehabilitation of the debtor in either a liquidation or reorganization case.

The exceptions to the automatic stay are enumerated in 11 USC 362 (b). Non-dischargeable debts include the following: debts incurred through fraud or false pretenses, unscheduled debts and educational loans to name a few. Whenever attempting to discern whether or not a particular action is excepted from the stay, one should be aware of the fact that these exceptions were crafted deliberately and with precision and were intended as a matter of policy to permit actions that would otherwise be subject to the stay. It is for this reason that exceptions to the stay should be read narrowly. Violations of the stay may cause the violator to be subject to damages and/or contempt citations.

11 USC 362 (d) provides a mechanism for a party in interest to obtain relief from the stay, such as by obtaining an order terminating, annulling, modifying, or conditioning the stay. Section 362 (d) provides the grounds for relief from the stay, and Bankruptcy Rule 4001, provides the procedural vehicle to obtain such relief from the bankruptcy court.

The duration of the stay is generally addressed by 11 USC 362 (c). Pursuant to section 362(c), acts against property of the estate in bankruptcy are stayed, as provided for in 362 (a), unless relief from the stay was granted earlier by the court, until such time as the property is no longer property of the estate (property is no longer property of the estate after abandonment, exemption, confirmation of a plan); with respect to the automatic stay against a debtor, (a) they continue until the earliest to occur of, (1) the case is closed, (2) the case is dismissed (3) the debtor is granted or denied a discharge or (4) relief from stay is granted.

The automatic stay as to property of the debtor expires 30 days after the filing of the bankruptcy petition under Chapter 7, 11 or 13 if a previous case was dismissed within one year of the pending case being filed, unless the court extends the stay upon motion filed and heard prior to the expiration of the 30 days. See §362(c)(3). This rule does not apply to property of the estate. Real property owned by the debtor as of the date of filing is property of the estate. In comparison, §362(c)(4)(A) provides that if the debtor has had 2 or more cases dismissed within one year of the filing of the current case, no stay (as to either property of the debtor or property of the estate) comes into effect. In this instance, a mortgagee may foreclose without first obtaining relief from stay. However, we require

an order lifting stay prior to insuring real property. Neither of the above sections mentions the co-debtor stay. The co-debtor stay comes into play in the case of a consumer debt in a chapter 13, to protect a co-obligor or owner of property pledged to secure a consumer debt. Relief from co-debtor stay would be necessary prior to foreclosure under such circumstances even if relief from stay were not.

Discharge and Section 522(f) Lien Avoidance

It is very important to understand what a discharge does and does not do. A discharge releases the debtor from any further personal liability for his scheduled prepetition debts. A discharge does not discharge the debtor's real property from the *in rem* liens against the real estate that survive bankruptcy. For example, a judgment docketed against the debtor prior to his filing a petition in bankruptcy, remains as an *in rem* lien against his real property even after he obtains a discharge in bankruptcy. The debtor is simply no longer personally liable on the judgment; nonetheless, the judgment remains an *in rem* lien against the real estate of the debtor. In order to annul these liens, it requires an order avoiding the lien in the pending bankruptcy proceeding, or an adversary proceeding under some operative provision of the Bankruptcy Code, for example 11 USC 547 (Preferences), 11USC 548 (Fraudulent Transfers) etc., or a sale of the real estate free and clear of the liens under 11 USC 363 (f) of the Code.

Since the automatic stay terminates upon the granting of a discharge to the debtor, section 524 (a) replaces it with a permanent injunction which restrains any acts or legal proceedings to collect a discharged debt as a personal liability of the discharged debtor; it does not affect debts which were held to be non dischargeable under section 523. Again, it does not operate to discharge ***in rem*** liens that survive the bankruptcy case.

In summation, the basic rule of thumb is that liens pass through bankruptcy unaffected, unless the debtor or trustee affirmatively moves to avoid, value or strip off the lien. The entry of the discharge has no effect, in and of itself, on a prepetition lien except that the entry of the discharge enjoins and prevents the attachment of the lien to any after-

acquired property (assuming for our purposes that the lien secures a debt that is discharged). As a practical matter, when insuring a transaction involving after-acquired property, it would be prudent to record the discharge order in the probate records so that it is clear from a review of the probate records that the property was acquired after the entry of the discharge.

In order to avoid a lien pursuant to 11 USC §522(f) you must first determine whether the lien is a judicial lien, and then you must determine whether the judicial lien impairs an exemption. Judicial liens are those created by a legal or equitable process or proceeding, and includes judgment liens, attachment liens, garnishment liens, and execution liens. A lien arising out of a domestic support obligation (alimony, maintenance, or support) is not subject to lien avoidance. See § 522(f)(1)(A).

The exemptions are listed on Schedule C of the bankruptcy petition. In Alabama, the only real property exemption is the homestead exemption, which is limited to $5,000 per spouse. No exemption is available for non-homestead real property in Alabama. In determining whether the property is the debtor's homestead, the determinative date will be the date of the petition.

Assuming the property is claimed as exempt, the next step is to determine to what extent, if any, the lien impairs that exemption under the formula set forth in § 522(f)(2). The formula provides that there is no impairment if the value of the property is more than the sum of the liens against the property plus the debtor's exemption. The value of the property for this determination should arguably be the replacement cost for the property. However, there is no statutory authority directly on point (as opposed to personal

property, which § 506(a)(2) specifically establishes as replacement value without deduction for costs of sale or marketing). Debtors are commonly using the tax assessed value of the real property for purposes of completing the schedules, and then using the scheduled value for purposes of lien avoidance.

A very common and problematic issue is when the lien avoidance motion does not set out what value the debtor is using, and the order does not set out to what extent the lien is impaired. The Northern District of Alabama bankruptcy courts are now employing forms that attempt to clarify the formula, copies of which are attached hereto. Unfortunately, many motions have been filed and granted that make no reference to any numbers whatsoever. In that instance, the schedules are often the only guidance available as to what the value, amounts of other liens, and amount of exemption claimed and allowed would be. Practically, if you are asked to insure property and you are uncertain whether to list a lien as an exception, if the motion and the accompanying order do not specifically show that the lien is entirely exempted (based upon the formula set forth above), an exception should likely be made out of an abundance of caution.

Another potential problem in applying the § 522(f) formula is in the case of "exempt" property owned jointly by a debtor and a nondebtor spouse. The courts are split on whether the formula must be applied literally, which can lead to a windfall and shield equity for the debtor, or whether the formula must be adjusted to avoid such result as inequitable and unintended. The 11th Circuit has ruled that the formula must be adjusted to reflect the portion of the debt the lien secures attributable to the debtor's ownership share of the property. In re Lehman, 205 F.3d 1255 (11th Cir. 2000).

Sales *other than* in the ordinary course of the debtor's business

In order to properly understand the concept of sales other than in the ordinary course of the debtor's business, a little background is in order. 11 USC 363 (b) (1) provides that the Trustee (or the debtor-in- possession, hereinafter DIP), AFTER NOTICE AND A HEARING, may use, sell, or lease, other than in the ordinary course of business, property of the estate. To understand this provision providing for sale, we must understand the bankruptcy concept of AFTER NOTICE AND A HEARING. 11 USC 102 (1) provides, in pertinent part,

> that "after notice and a hearing," or a similar phrase - (A) means after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances; but (B) authorizes an act without an actual hearing if such notice is given properly and if-
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> (i) such a hearing is not requested timely by a party in interest; or
>
> (ii) there is insufficient time for a hearing to be commenced before such act must be done and the court authorizes the act

The norm for sales other than in the ordinary course of debtor's business is pursuant to an order of sale after a hearing. Nonetheless, as is apparent from the definition of "after notice and a hearing," the Code contemplates sales of realty, other than in the ordinary course of business, without a hearing and a court order under some circumstances. A title insurance company will insist upon a confirmatory order of sale, a so called "comfort" order.

11 USC 363 (b) is the code provision which provides for sales of property of the estate other than in the ordinary course of the debtor's business. Usually, these sales will involve a chapter 7 liquidation case, or a chapter 13 case, and on some occasions a chapter 11 reorganization case. When section 363 is utilized for a chapter 11 or chapter 13 case, it must be employed pre-confirmation, since confirmation re-vests title to property of the estate in the debtor.

Title procedures for sale other than in the ordinary course of business.

Prior to insuring a property involved in a 363 sale, a title company will need to examine a copy of the petition in bankruptcy; a copy of the debtor's schedules; a copy of the notice to creditors of the bankruptcy filing along with its proof of service. In addition, the company will need to examine a copy of the motion to sell, along with proof of service on all creditors, and a copy of the final non-appealable order of sale. Federal Rule of Bankruptcy Procedure (hereinafter, BR) 8002 provides that the notice of appeal, if any, shall be filed with the Clerk of the Bankruptcy Court within 14 days of the date of the entry of the judgment, order, or decree appealed from; therefore, if no appeal is filed within that 14 day period the order of sale is final. The transaction should not be insured until the expiration of the 14 day stay (or other period as the court may order) has expired. The filing of a notice of appeal will not automatically stay the order approving the sale, and the appeal may be mooted by the failure to obtain a stay pending appeal. BR 6004 (h) provides that an order

authorizing the use, sale, or lease of property is automatically stayed until the expiration of 14 days after the entry of the order, unless the court orders otherwise.

It is important to make certain that the subject property has been scheduled as an asset of the estate. It is also essential that the notice of sale fully sets forth the intended transaction. BR 2002 (c) (1) requires the notice of sale to include the time and place of any public sale, the terms and conditions of any private sale, and the time fixed for filing of objections to sale. The notice is deemed sufficient if it generally describes the property. Where the sale is by contract, a copy of the contract should be annexed to the notice of sale. One must determine that the notice of sale was properly served on all creditors. BR 2002 (a) (2) provides for notice to creditors of not less than 21 days by mail of such proposed sale, unless the court for cause shortens the time period or directs another method of giving notice. Finally, one needs to determine whether or not any objections to the sale were filed. BR 6004 (b) provides that objections to the proposed sale shall be filed and served no less than 7 days before the date set for the proposed sale, or within the time otherwise set by the court. One can usually secure the clerk's minutes or obtain a clerk's certification of service and no objection. BR 6004 (f) provides that all sales not in the ordinary course of business may be by either private sale or public auction. The same rule authorizes the DIP or the trustee, as the case may be, to execute any instrument necessary to effectuate the transfer to the purchaser.

Sales *in* the ordinary course of the debtor's business

Sales in the ordinary course of debtor's business are provided for under 11 USC 363 (c). Pursuant to this provision, the trustee or DIP may effectuate a sale in the ordinary course of the debtor's business without notice and a hearing as discussed above. This kind of sale, without notice, hearing and an order of sale, can be very risky. In most real property transactions, it is highly unusual for a sale of property to be in the ordinary course of the debtor's business. Keep in mind that if the sale is effectuated without notice, hearing, and an order of sale, and if it is not in fact a sale in the ordinary course of the debtor's business, the sale will be void in violation of the automatic stay.

11 USC 549 permits post petition transfers to be avoided that were not authorized under 11 USC 363 or by a court order. Presumably, entities that are in the business of buying and selling real estate would qualify- a small home builder or developer for example. Nonetheless, extreme caution is needed in this type of transaction, since no notice or hearing pertains to these sales, and therefore the 11 USC 363 (m) protections afforded a good faith purchaser, protecting such purchaser from a reversal or modification on appeal, would arguably not apply here. The transfer would thus be void in violation of the automatic stay, or would be subject to being avoided pursuant to the application of 11 USC 549. Due to these extreme risks, in the event there is any question as to whether or not the sale is in the ordinary course of business, an order of sale on notice with a hearing should be sought. As in a sale in other than the ordinary course, ownership of the property must be in the estate; in the event of an unresolved dispute as to ownership the sale should not go through.

As in the sale not in the ordinary course of business, copies of the petition, and debtor's schedule should be examined. The copy of the notice to creditors of a bankruptcy filing along with its proof of service also needs to be scrutinized.

Sales Free and Clear of Liens under 11 USC 363(f)

The trustee or DIP may sell real property pursuant to 11 USC 363 (b) (sales other than in the ordinary course of business), or pursuant to 11 USC 363 (c) (sales in the ordinary course of business), free and clear of any interest in such property of an entity other than the estate, with the liens attaching to the proceeds of sale, only if one of the five elements of 363 (f) is present. 11 USC 363 (f) provides:

(f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if-

> (1) applicable non bankruptcy law permits sale of such property free and clear of such interest;-not applicable in real estate law;
>
> (2) such entity consents; -sometimes this is applicable
>
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;-sometimes this is applicable
>
> (4) such interest is in bona fide dispute;-if this is the case, the order should say so; or
>
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."-not typical in real estate law

363 (f) is written in the disjunctive, meaning the sale free and clear of liens may be effectuated if any one of the elements of 363 (f) has been met. This disjunctive format does not mean that you cannot mix and match the five elements? Many title insurers have gone along with this approach as well, provided the circumstances are right, and that the sale was effectuated by a final order on clear notice. For example, assume a debtor in a chapter 13 bankruptcy case proposes a sale free and clear of liens, when the sale proceeds

are sufficient to pay off the first mortgage lien and where the second mortgagee consents to the sale, although the proceeds will not fully pay off the second mortgagee's lien. Courts have permitted this to occur. Another example is where a trustee negotiates a settlement with one lien holder, to take less than the full value of his lien, and the amount of the lien, as settled, is used, in computing the aggregate value of all liens under the (f) (3) calculation (see In re Van Metre, Inc. 155 B.R.118 (Bankr. E.D. Va. 1993)). The garden variety sales under 363 (f) occur when the sale price exceeds the face value of all the liens on the property, or the entities with interests in the property, for example, all secured creditors consent to the sale. When employing mix and match scenarios it is advisable to consult senior title counsel.

Clearly, in any sale free and clear of liens, you need to examine carefully the elements reviewed earlier in connection with sales in or out of the ordinary course of business. In addition, you will want to be certain that all the secured parties listed in the title report have been served with the notice of motion for sale. The notice should be clear and indicate that a sale will be made free and clear of liens. Unsecured creditors are also entitled to notice and have a right to object to the sale for cause. Make absolutely certain that the estate has title and that title is not in dispute.

Any sale pursuant to 11 USC 363 (f) is subject to the adequate protection requirements of 11 USC 361. Adequate assurances, adequate protection, and adequate disclosure, these are the watchwords in bankruptcy. The lien creditor must be given something to replace the lien he is losing. Courts usually have deemed that adequate protection is met when the liens are by court order made to attach to the proceeds of sale

subject to further disposition by the court. In a section 363 sale, the real estate collateral is replaced by cash collateral - the proceeds of sale.

All interested parties should be served with proper notice and disclosure of the sale, and a final non-appealable order of sale should be entered. The order should provide that the sale is being made free and clear of all liens, with the liens attaching to the proceeds of sale, subject to further disposition of the court. The conveyance will usually recite that it is being made free and clear of all liens pursuant to an order of sale, reciting the court and venue. The order should be recorded in the land records which will necessitate the need of a certified copy of the order.

Unfortunately, not all motions and orders are created equal. For instance, a motion may seek permission to sell certain property, making no reference to any code section or using the words, "free and clear of liens." Then, to compound this error, the order will then be entered simply granting the motion, providing no guidance as to what code section authorized the sale. In this situation, even assuming all interested lien holders received appropriate notice, this transaction should not be insured over existing liens in the absence of clarification from the court that the sale was free and clear.

Another common scenario is one where the sale purports to be free and clear of liens, but erroneously and with no fraudulent intent informs the judge that there are no liens on the property. Instead, there is a lien, shown in the schedules, and for which a proof of claim has been filed. No one catches the inadvertent mistaken statement in the motion. The lien holder received notice of the motion to sell the property free and clear of liens but did not object, and an order is entered authorizing the sale free and clear of

liens. In this situation, arguably, the lien has been extinguished notwithstanding the error in the motion. However, none of the five elements conditioning a sale free and clear of liens has been met, unless the failure to object if found to be implicit consent of the lien holder. The best practice would be to require the debtor's attorney to correct the motion and refile, or seek an amended order squarely addressing the issue.

One final comment concerning sales free and clear of liens, title insurers usually will not, nor should they, omit open real estate taxes and assessments, even where the order provides for sale free and clear of all liens, unless the taxes and assessments are paid in full at closing. Many municipalities refuse to remove the taxes from the tax rolls even in the face of an order. This presents a major pragmatic problem and no title company wishes to be placed in the position where it needs to retain counsel to have the taxes removed.