I Surrender! Strategies for Getting Rid of Unwanted Collateral

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TAKE MY HOUSE – PLEASE!!
Getting Rid of Encumbered Property

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I. Problems a debtor faces when the lender won't foreclose
   A) Future HOA fees
      i) A debtor's personal liability for HOA dues continues post-petition and is unaffected by the discharge. *Foster v. Double R Ranch Assoc. (In re Foster),* 435 B.R. 650 (9th Cir. BAP 2010).
      ii) HOA dues are non-dischargeable pursuant to 11 U. S.C § 523(a)(16).
      iii) HOA dues are also non-dischargeable under a "hardship" discharge pursuant to Section 1328(b).
   B) Property taxes.
   C) City and municipality fines for failure to maintain property.
   D) Damage claims from accidents that occur on the property— for example, squatters, mosquito-infested swimming pools and natural gas leaks
   E) If the bank takes its sweet time to foreclose, this situation can go on for years and put the Debtor in debt all over again.

II. The lender has no explicit duty to foreclose
   A) A debtor cannot compel the lender to foreclose.
   B) A lender's failure to foreclose is not a violation of the discharge injunction.

III. "Surrender" alone is not helpful
   A) Surrendering property in a chapter 13 plan does not transfer title of the property. *See In re Rosa,* 495 B.R. 522, 524 (Bankr. D. Haw. 2013) ("[S]urrender does not transfer ownership of the surrendered property. Rather, 'surrender' means only that the debtor will make the collateral available so the secured creditor can, if it chooses to do so, exercise its state law rights in the collateral.")
   B) "Surrender" simply means that the Debtor will not oppose the transfer of the house and, absent some further action (foreclosure, short sale, deed in lieu),the Debtor remains the owner and bears the burdens of ownership.

C) Surrender does not divest the debtor of the responsibilities of ownership.
D) Surrender does not create is any requirement for the lender to foreclose.

IV. Chapter 7 is not helpful
A) If the home is "underwater," a chapter 7 trustee will simply abandon it under § 554, and the title will remain in the debtor, subject to the ongoing charges and liabilities noted above.

V. Chapter 11 may provide a remedy
A) "Dirt for debt"—a plan may require a secured creditor to accept collateral in satisfaction of its secured claim. *Arnold & Baker Farms v. U.S. (In re Arnold & Baker Farms),* 85 F.3d 1415, 1423 (9th Cir.1996); *In re Sandy Ridge Development Corp.,* 881 F.2d 1346, 1350 (5th Cir. 1989).
B) "Dirt for debt" satisfies the requirements for "cramdown" under 11 U.S.C. § 1129(b)
i) Debtor's plan must be "fair and equitable"
ii) For a lender holding a secured claim, the plan may provide for the lender to realize the "indubitable equivalent" of its secured claim.
iii) Plans proposing to transfer to a creditor the property to which its lien attaches are "fair and equitable" because the creditor receives the indubitable equivalent of its secured claim. *See Sandy Ridge,* 881 F.2d at 1350 (5th Cir.1989) ("[C]ommon sense tells us that property is the indubitable equivalent of itself.").

VI. Relevant provisions in chapter 13
A) 11 U.S.C. § 1325
i) Section 1325(a)(5) sets out the requirements for treatment of a secured claim in a chapter 13 plan.
ii) In order to confirm a plan, the plan must either:
(1) Be accepted by the secured creditor;
(2) Pay the debt as allowed under chapter 13; or
(3) Surrender the property to the secured creditor.
iii) Plan cannot be confirmed unless proposed in good faith. (§ 1325(a)(3))

B) 11 U.S.C. § 1322
i) Section 1322 details what may be included in a chapter 13 plan, what must be included in a chapter 13 plan, and what may not be included in a chapter 13 plan.
ii) Section 1322(b) states what may be provided in a chapter 13 plan.

iii) Relevant options:
(1) § 1322(b)(8) - a plan may provide for the payment of all or part of a claim against the debtor from property of the estate or property of the debtor.
(2) § 1322(b)(9) - allows a debtor to propose a plan to "provide for the "vesting" of property of the estate, on confirmation of the plan or at a later time, in the debtor or in any other entity."
(a) "Vesting" involves a transfer of ownership. "The plain meaning of the term 'vest' is to transfer ownership or title." *United States ex rel. DRC, Inc. v. Custer Battles, LLC,* 376 F. Supp. 2d 617, 619, 632 (E.D. Va. 2005). Congress is presumed to have chosen deliberately the words it includes in a statute. *Univ. of Texas Southwestern Med. Ctr. V. Nassar,* 133 S.Ct. 2517, 2529 (2013)
(b) There is no requirement here that the recipient consent.

VII. Option 1: payment by transfer under § 1325(a)(5)(B) and § 1322(b)(8)

Example: Chapter 13 Debtor has a home valued at $65,000.00 and owes his lender, Bank of Kilpatrick, a total of $60,000.00. Debtor wants to get rid of the house in the Chapter 13 Plan.

Debtor provides the following language in a proposed Chapter 13 Plan:

> Pursuant to 11 U.S.C. § 1325(a)(5)(B)(ii) and § 1322(b)(8), Debtor transfers her improved Real Property located at 111 Dreamy Lane, Houston, Texas 77033, valued at $65,000.00 to Bank of Kilpatrick, in full payment of its secured claim of $60,000.00.
>
> Upon entry of a confirmation order confirming this Chapter 13 plan, title of the Property located at 111 Dreamy Lane, Houston, Texas 77033, shall be transferred to Bank of Kilpatrick.
>
> Bank of Kilpatrick shall retain its lien in the Property located at 111 Dreamy Lane, Houston, TX 77033. There are no junior mortgages or any other liens on this property.
>
> Upon confirmation of this plan, Debtor may file a copy of any Order confirming this Chapter 13 plan in the real property records to reflect transfer of title to Bank of Kilpatrick.

A) Analysis of 11 U.S.C. § 1325(a)(5)(B) under Option 1:
   (1) As discussed above, the debtor must pick one of three ways to treat secured claims.
   (2) Under this strategy, the debtor chooses the second option, paying the debt as allowed under §§ 1325(a)(5)(B) and 1322(b)(8)).
   (3) This is consistent with claim treatment in chapter 11 cases (dirt for debt).
   (4) Under § 1325(a)(5)(B) the plan must provide the following:
      1. the lender retains the lien securing such claim;
      2. the value, as of the effective date of the plan, of "property to be distributed under the plan" on account of such claim is not less than the allowed amount of the claim (necessarily satisfied, since the property itself establishes the amount of the secured claim); and
      3. "if" the property is to be distributed in the form of "periodic payments," the payments must be in equal monthly amounts. (The equal payment rule does not apply here, but the statutory provision recognizes the possibility of satisfaction of the claim other than by periodic payments).

B) 11 U.S.C. § 1322(b)(8)—expressly authorizes "payment of all or part of a claim against the debtor from property of the estate or property of the debtor."

C) Lender's objection under 11 U.S.C. § 1322(b)(2)
   (1) The lender may argue that such a "plan" attempts to modify its rights since it has a claim secured by a security interest in real property that is the debtor's principal residence.
   (2) Possible responses to this "anti-modification" argument:
      (a) If the debtor was not living in the home on the day the case was filed, many courts conclude that the home is not the debtor's principal residence. *E.g., In re Abdelgadir,* 455 B.R. 896. 903 (B.A.P. 9th Cir. 2011); *In re Collins,* Case No. 14-34816 (Bankr. S.D. Tex. April 7, 2015)(the proper date for determining a debtor's principal residence is the petition date because § 1322(b)(2) references a "claim" and "claims" are determined as of the petition date). The minority view is that the debtor's use of property is determined at the time of creation of the lien. *E.g., In re Abrego,* 506 B.R. 509, 515-16 (Bankr. N.D. Ill. 2014) (collecting cases).
      (b) Paying the lender with its collateral does not modify any of the lender's rights.

(c) All of the lender's state court rights are subject to federal law and the Bankruptcy Code trumps its state court rights.

(i) "Even where state law creates the property interest, it must yield where it conflicts with the provisions of the Bankruptcy Code." *Patriot Portfolio, LLC v. Weinstein (In re Weinstein),* 164 F. 3d 677, 683 (1st Cir. 1999)

D) Objection under 11 U.S.C. § 1325(a)(7) (lack of good faith)

(1) The debtor may respond with the following points:

(a) The lender has not filed a motion to lift stay.

(b) The debtor has moved out or will move out as soon as the plan is confirmed.

(c) The debtor's proposed plan makes the foreclosure process easier and cheaper for the lender.

VIII. Option 2: surrender combined with vesting

Example: Under the same facts as in Option 1, the Debtor provides the following language in the Chapter 13 Plan:

> Pursuant to 11 U.S.C. § 1325(a)(5)(B)(iii) and § 1322(b)(8) and (9), Debtor surrenders her interest in the improved Real Property located at 111 Dreamy Lane, Houston, Texas 77033, valued at $65,000.00 to Bank of Kilpatrick, in full satisfaction of the Mortgage, Note and any outstanding fees.
>
> Upon confirmation of this Chapter 13 plan, title of the Property located at 111 Dreamy Lane, Houston, Texas 77033, shall vest in Bank of Kilpatrick.
>
> Bank of Kilpatrick shall retain its lien in the Property located at 111 Dreamy Lane, Houston, TX 77033. There are no junior mortgages or any other liens on this property.
>
> Upon confirmation of this modified plan, Debtor may file a copy of any Order confirming this Chapter 13 plan in the real property records to reflect transfer of title to Bank of Kilpatrick."

A) 11 U.S. C. § 1322(b)(9) allows a debtor to propose a plan to "provide for the vesting of property of the estate, on confirmation of the plan or at a later

time, in the debtor or in any other entity," and vesting includes a present transfer of ownership.

B) 11 U.S.C. § 1325(a)(5)
   (1) This section sets out the requirements to confirm a chapter 13 plan as it relates to treatment of a secured claim.
   (2) In order to confirm a plan, the plan must either be:
      (a) Accepted by the secured creditor;
      (b) Pay the debt as allowed under Chapter 13; or
      (c) Surrender the property to the secured creditor

C) 11 U.S.C. § 1325(a)(3)
   (1) Plan must be proposed in good faith.
   (2) Confirmation could be denied if a debtor attempts to use § 1322(b)(9) to transfer property back to the lender to avoid responsibility for a nuisance or environmental problem.

D) Recent Cases Dealing with Surrender & Vesting in Chapter 13 plans:
   i) *In re Sagendorph,* 2015 WL 3867955 at *4-5 (Bankr. D. Mass. June 22, 2015):

> A correct application of the relevant provisions of the Bankruptcy Code permits a chapter 13 debtor to propose a plan that provides for transferring title to mortgage real estate to the mortgagee in full satisfaction of its claim subject to the mortgagee's right to object, in which case the court must determine of the plan has been proposed in good faith, is otherwise in compliance with the Code, and should be affirmed. This approach maintains the integrity of both § 1325(a)(5) and § 1322(b) and is consistent with the most basic principles of bankruptcy restructuring as enunciated in the Code's reorganization provisions embodied in chapters 11, 12 and 13.
>
> It seems a self-evident truth that wherever possible the reorganization rights of chapter 11 and chapter 13 debtors should be the same.

   ii) *In re Rosa,* 495 B.R. 522 (Bankr. D. Haw. 2013)
      (1) Conclusion by the Court:
         (a) Surrender can be augmented by § 1322(b)(9), which provides that a plan may "provide for the vesting of property of the estate, on confirmation of the plan or at a later time, in the debtor or in any other entity."

(b) However, a chapter 13 plan cannot vest surrendered property in the mortgage holder without its consent.

(c) The plan was confirmed because the lender did not object to confirmation and the court found that "its failure to object means that it has accepted the plan."

iii) *In re Rose,* 512 B.R. 790 (Bankr. W.D.N.C. 2014)

(1) Comes to a similar result as the *Rosa* court, but offers greater protection to the mortgage holder.

(2) Conclusion by the Court:

(a) Surrender only transfers title to a secured creditor if the creditor accepts the collateral. As to vesting, *Rose* agrees that title cannot transfer without the secured creditor's consent, mentioning the potential problems that accepting title could impose on a mortgage holder.

(b) The lender's failure to object to vesting does not constitute consent, and so the debtor is directed to deliver a quitclaim deed to the mortgage holder, with the deed becoming a final conveyance only if the mortgage holder fails to take definitive action within 60 days after receiving the deed.

iv) *In re Watt*, 520 B.R. 834 (Bankr. D. Or. 2014)

(1) This decision was reversed, 2015 WL 1879680 (D. Or. April 22, 2015), and has been appealed to the Ninth Circuit, Docket No. 15-35484. However, consistent with *Sagendorph,* it takes a different view of vesting than the *Rose* and *Rosa* courts.

(2) This court holds that surrender under § 1325(a)(5) does not require acceptance by the secured creditor and that § 1329(b)(9) allows a plan to provide for vesting without consent from the lender.

(3) Its rationale is plain meaning.

(4) *Watt* states that the good faith requirement of § 1325(a)(3) would prevent a plan from forcing a third party to accept property that is a nuisance or beset with environmental problems.

IX. Other options for eliminating unwanted collateral

A) Short Sale

(1) This occurs when a homeowner sells his home to a third party for less than the total debt remaining on the mortgage and the lender agrees to accept the proceeds in exchange for releasing the lien on the property.

(2) Seller submits an application which usually includes a financial statement re income/expenses.
(3) Proof of income, tax returns and bank statements, and a hardship letter are provided to the lender
(4) Lenders generally require an offer on the table from a third party before they will consider a short sale.

B) Deed in Lieu of Foreclosure
(1) A deed in lieu of foreclosure is a transaction in which the homeowner/borrower transfers the property by deed back to the lender voluntarily in return for negotiated resolution of the debt.
(2) Some lenders require the borrower to request a loss mitigation package from the lender.
(3) Borrower provides financial information including proof of income, tax returns, bank statements and hardship letter.
(4) Many lenders require the borrower to try to sell the home for at least 90 days before it will consider accepting a deed in lieu.

C) Sale Subject to the Mortgage
(1) No application of § 363(f).
(2) No modification of mortgagee's rights.
(3) Buyers may be available.

D) Transfer by Quit Claim Deed
(1) Deeds must be prepared and executed in the form required under applicable nonbankruptcy law.
(2) The deed must be accepted by the new owner.
(3) The recipient of the transfer must be capable of owning property or the transaction may be seen as fraudulent.

E) Lease the property until the lender forecloses
(1) Use the rent to pay the ongoing HOA dues, taxes and maintenance.

F) Remain in the property without making mortgage payments.

What's Wrong With 363
Asset Sales?
The Problems and
Some Proposed Solutions
NA
Chapter
October 2013
Santa Fe, New Mexico

What is a 363 Asset Sale?

- An asset sale in bankruptcy is the debtor's sale or transfer of estate property to a third party outside of the ordinary course of business, which requires notice to creditors and interested parties, a hearing, and court approval.
- The problematic asset sales are those that sell *substantially all* of the debtor's assets.

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How Does a 363 Asset Sale Work?

- An asset sale requires court approval sought by motion, on notice to all parties "who have liens or other interests in the property being sold." The court conducts a hearing. Sales can be done privately or by public auction and bidding among prospective purchasers is intended. 363(f) and Rule 6004
- The validity of an asset sale to a BFP is unaffected by an appeal of the sale order unless the objecting party obtains a stay. 363(m). An order approving the sale is stayed for 14 days after the order, unless the court orders otherwise. R. 6004(h)

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How Does a 363 Asset Sale Work?

- Under 363(e), the court may prohibit or condition a sale "as is necessary to provide adequate protection" to an interest.
- The "property interests," of which the assets are being sold free and clear, are expected to be "satisfied" by the proceeds of the sale, thereby providing the property interest holder with adequate protection of its interest.

Free and Clear Asset Sale Criteria

The debtor's property may be sold *"free and clear of any interest in such property"* under 363(f), but only if:

(1) Applicable non-bankruptcy law permits the sale free and clear of the interest;

(2) Entity holding the interest consents;

(3) The interest is a lien and the sale proceeds are greater than the value of all liens on the assets sold;

(4) An interest is in bona fide dispute; or

(5) An entity could be forced to accept monetary satisfaction of the interest .

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Basic Bankruptcy Concepts

- The Code is intended to provide equity and fairness to creditors and to foster their recovery.
- The Code gives debtors a "fresh start," not a "free pass."
- The Code protects the debtor's estate, not non-debtor third parties.
- The Code is intended to satisfy monetary claims against the debtor with property of the estate.
- To the extent possible, sales should satisfy all interests affected by the "free and clear" sale from the proceeds of the sale – holders of those interests should have clear notice of what is considered subject to the sale *prior* to approval.

Basic Bankruptcy Concepts

- Section 363 is an enabling statute to aid equitable estate administration, and does not preempt, override or otherwise affect state law. *Integrated Solutions v. Service Support Spec.*, 124 F.3d 487 (3d Cir. 1997).
- The Code sets forth the limits of a debtor's rights as well as the court's jurisdictional limits.
- Bankruptcy is not a haven for debtors or purchasers to avoid compliance with State and federal laws.

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Newer Concepts

- *Espinosa:* Bankruptcy court *sua sponte* not only *can* direct the debtor to conform a plan to the Code, but it *must* do so and it has an affirmative duty to confirm only lawful plans.
- By extension, the bankruptcy court has a duty to approve only asset sales that comply with the Code *and* are lawful under non-bankruptcy law.

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Newer Concepts

- *Stern v. Marshall*: Bankruptcy court lacks jurisdiction to determine State law counterclaim independent of bankruptcy law and "not necessarily resolvable by a ruling on the creditor's proof of claim"
- By extension, does a bankruptcy court have jurisdiction to determine a State law claim or issue in the context of a 363 asset sale, such as successor liability for products or environmental liability, tax rate-setting, labor law, etc.?

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Why 363 Needs Fixing...

- Sub Rosa Plan. The sale of substantially all of a debtor's assets prior to a disclosure statement and plan being proposed results in the elimination of the traditional safeguards of good faith, transparency, fairness, equity, and creditor acceptance built into the plan process, which are necessary for confirmation under 1129.

- Fairness. Court approval of a 363 sale is based on the debtor only showing "business justification" or "a good business reason" (*See Lionel, Gucci, Iridium, Chrysler, GM, et al.*); whether the sale is in the best interest of creditors is *not necessarily a factor considered*.

Why 363 Needs Fixing...

- Who benefits? The debtor and its professionals primarily benefit from asset sales that are followed by liquidation (professional fees can be exceedingly high).
- The stalking horse bidder benefits by virtue of greater access to information and therefore holds a superior position to other potential bidders (break up fees are excessive).
- After a sale, creditor recovery under the plan allocating the sales proceeds typically is far less than the cherry-picked creditors whose liabilities are assumed by the buyer in the sale.

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Why 363 Needs Fixing…

- Not Arms Length. An asset sale is most unfair when (1) a purportedly competitive third-party purchaser is an insider or affiliate, (2) the "bidding" is not truly competitive, or (3) the purchaser merges with or merely continues the business while its successor liability is cut off without regard to applicable non-bankruptcy law (e.g., *GM, Chrysler, Urban Telecomm.)*.

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Why 363 Needs Fixing…

- Wrong Chapter? A sale of "substantially all" of the debtor's assets outside of a plan means that the debtor plans to liquidate and is therefore in the wrong chapter. Selling off assets and paying creditors is what Chapter 7 trustees do. There is no justification to allowing a debtor to retain control rather than bringing in an independent Chapter 7 to fairly administer and liquidate the estate equitably.

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Why 363 Needs Fixing…

- Lack of Transparency. Asset sales, particularly ones done urgently, do not sufficiently identify either the precise assets being sold free and clear, or the specific interests being affected. Even in these "melting banana" cases (to quote Chief Justice Roberts in *Piccadilly*), the debtor typically completes the sale arrangements pre-petition – including setting artificial deadlines with the buyer – and then uses those same deadlines to force the process forward in its own and the buyer's best interests, rather than in the best interests of creditors.

Why 363 Needs Fixing...

- Expansive Interpretation. Courts broadly construe 363 (f) to find certain governmental interests to be "interests in such property" from which the assets can be sold "free and clear" - when those interests are statutory requirements and are not *per se* interests in the assets being sold.
- Sale for Purpose of Eliminating Liability. Asset sales are being specifically used for the purpose of eliminating a range of the debtor's *and* the purchaser's compliance obligations and liabilities, including products and environmental liabilities, contractual, pension, labor, and tax obligations.

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The Problem: Sub Rosa Plan

- Proposed Solution 2

Amend 363(f) to require that when substantially all of the debtor's asset's are to be sold outside of a plan, good cause must be shown, including:

(a) The sale is in the best interest of creditors and will result in a greater recovery under the liquidation plan;

(b) The assets were marketed in accordance with generally accepted practices in the industry; and

(c) There is a factual basis for *Picadilly's* "melting banana" urgency, which is not debtor/buyer-created.

Why 363 Needs Fixing...

- No Stay/No Appeal Rights. Sale orders routinely eliminate or significantly shorten the 14-day stay provided in Rule 6004(h), which results in immediate statutory mootness of any objector's appeal under 363(m).
- Permit Transfer. Courts routinely approve sales that provide for the debtor's unilateral transfer of permits to the buyer without required government authorization.

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The Problem: Sub Rosa Plan

Proposed Solution 1

Amend SOFA to add the following Qs:

(a) Did pre-bankruptcy planning include the sale of substantially all assets?

(b) Was a stalking horse identified pre-petition and what agreements were made at that time (breakup fees, timing of sale, etc.)?

(c) What were the pre- and/or post bankruptcy marketing efforts undertaken? (identify other prospective buyers who expressed interest)

(d) What claims will be satisfied by the sale and what is the 506(a) value of those claims?

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The Problem: Wrong Chapter

Proposed Solution :

Amend Rule 6004 to provide that when "substantially all" asset sale is proposed, an 1104 trustee is appointed:

(1) To obtain limited DIP financing for a 3-4 month period and limit professional fees;

(2) To evaluate the value of assets to be sold and the liens/ interests in those assets;

(3) To assess creditor recovery under reorganization versus liquidation;

(4) To assure competitive bidding and an arm's length transaction; and

(5) To move the debtor to a chapter 7 depending on results of trustee evaluation/assessment.

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The Problem: Lack of Transparency

Proposed Solution:

Amend Rule 6004 to require the sale motion to list the precise assets being sold and to identify the specific interests affected, making clear which of the seller's environmental, pension, contractual and other obligations the purchaser intends to assume, which liabilities will remain with the debtor, which liabilities will be satisfied (or not) by the proceeds from the sale, and whether the buyer asserts it is exempt from any statutory liabilities by reason of having bought the assets in the 363 sale.

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The Problem: Expansive Interpretation of 363(f)

The Trend. Courts are reading the term "free and clear of any interest in such property" to include ANY kind of liability or obligation, including experience ratings, environmental liability (purchaser as successor), tort and products liability claims, pension funding obligations, non-monetary rights such as the ability to use standby travel vouchers, etc.

There is no li[illegible]treated as "an interest in" property [illegible]sis. All corporate obligations are in some w[illegible]nected to" the corporate assets. Thus, under this analysis virtually any corporate obligation can be considered to be "an interest in" the assets being sold.

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The Beginning of the Trend

- *In re Leckie Smokeless Coal*, 99 F.3d 573 (4th Cir. 1996) (debtor coal mine operators could sell assets free and clear of pension benefit obligations under the Coal Act because assets being sold were still to be used for coal mining purposes).

The Beginning of the Trend

- *In re Trans World Airlines*, 322 F.3d 283 (3d Cir. 2003) (assets sold "free and clear" of employee travel voucher claims, government discrimination claims against TWA because the airline assets being sold were "related to" the discrimination claims at issue).
- *In re Colarusso*, 295 B.R. 166 (B.A.P. 1st Cir. 2003) (363's phrase "interest in such property" covers more than *in rem* interests and is at least as broad as the term "property of the estate" under Section 541).

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The Trend Picks Up Serious Speed

- *In re Chrysler*, 576 F.3d 108 (2d Cir. 2009) (Old Chrysler's assets were sold potentially "free and clear" of New Chrysler's successor liability for future tort claims caused by Old Chrysler's cars)*
- *In re General M* ankr. S.D.N.Y. 2009) (same, re

* *Chrysler* court refused to define extent of bankruptcy court's authority to extinguish future tort claims (and thereby run afoul of due process) until "presented with an actual claim for an injury that is caused by Old Chrysler, that occurs after the Sale, and that is cognizable under state successor liability law."

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A Narrower Reading of 363(f)

- *Zerand-Bernal v. Cox*, 23 F.3d 159, 162- 64 (7th Cir. 1994) (363(f) does not bar products liability action against asset purchaser because such an action was not an effort to enforce a lien from which assets were free and clear; bankruptcy court does not have power to order such a release of liability for the successor if its exists).
- *In re Wolverine Radio*, 930 F.2d 1132, 1147 (6th Cir. 1991), ("interest" under 363 is one that attaches "to the property so as to cloud its title." thus, debtor's past experience rating was *not* an "interest").

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A Narrower Reading of 363(f);

Tax-Related Interests Excluded from 363(f)'s Reach

- *In re Eveleth Mines* 682 (BAP 8th Cir. 2004) (under Tax bankruptcy court must abstain w ssues are raised in motion to e r free and clear of tax calculati sdictional grounds bankr ying rejection of *Leckie* and *TWA* State tax action against the 363 p ebtor's mine was not barred by sale be ax calculation was not an "interest in" the property sold).
- .

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Defining "Interest in Such Property"

- The word "in" [such property] means something....
- 363 sales historically affected only *in rem* interests, such as UCC and other liens, mortgages, judgments and other classic real or personal property encumbrances that created direct rights in the assets being sold. *See* Collier 14th Ed. (1978).
- 363's original purpose was to make the assets marketable and the estate more easily administered, while protecting those secured interests, which attached to the sale proceeds. The sale merely transferred an interest holder's rights against a tangible asset into rights against the sale proceeds.

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Defining "Interest in Such Property?"

- The definition of a "property interest" is governed by State real property laws and the UCC, which construe it as a compensable right or security interest in real or personal property, carrying with it the right of enforcement (e.g., by foreclosure) against the property in which the holder has a direct interest.
- The Supreme Court, citing Blacks LD, says the commonly understood definition of a property interest is a "legal share in something; all or part of a legal or equitable claim to or a right in property." *Schwab v. Reilly,* 560 U.S. 770 (2010).

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Defining "Interest in Such Property:" Statutory Construction

- "The maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to Acts of Congress."

Jarecki v. G.D. Searle & Co.,

367 U.S. 303, 307 (1961)

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Defining "Interest in Property:" 363's Language

363 uses a variety of words (i.e., the "company" being kept) in discussing property interests - all have an *in rem* connotation :

(1) "security interest"

(2) "liens"

(3) "encumbrances,"

(4) "vested or contingent right in the nature of dower or curtsey"

(5) "undivided interest as a tenant in common, joint tenant, or tenant by the entirety"

(6) "co-owner"

The Problem: Expansive Reading of 363(f)

- Proposed Solution:

  Amend 363 to:

  (1) Clarify that "interest in property" means only direct *in rem* interests (liens, security interests, encumbrances, ownership interests) in the assets being sold for which the creditor can be required to accept money in satisfaction under non-bankruptcy law;

  (2) Specifically require that interests attach to the proceeds in the same order as under non-bankruptcy law; and

  (3) Exclude claims or interests that a party may be able to assert against a purchaser as a successor under applicable non-bankruptcy law.

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Justification

- Brings consistency to 363 with the usage of the term "interest" under the rest of the Code;
- Limits free and clear sales to interests that can be forced to accept monetary payments (resolving issues associated with easements and covenants and whether they can be eliminated by a free and clear sale);
- Eliminates cherry-picking by debtor and/or buyer to pay some creditors preferentially (e.g., by liability assumption), but not pay others who may hold claims in a similar class - or even higher priority);

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Justification

- Clarifies that successorship rights and liabilities are not affected by free and clear sale except as allowed by non-bankruptcy law;
- Clarifies that buyers cannot avoid their own liabilities under non-bankruptcy law that do not arise from claims against debtor;
- Preserves due process rights of future claimants (tort, products, environmental);
- Adds a clear statement about interests attaching to proceeds.

37

The Problem: Sales for the Sole Purpose of Liability Avoidance

Proposed Solution

Borrowing the intention behind the protective language in 1129(d), which prohibits confirmation if the plan's principal purpose is tax or securities law avoidance, 363 also should be amended to provide:

"On request of a party in interest that is a governmental unit, the court may not approve a sale of substantially all of the debtor's assets if the principal purpose of the sale is the avoidance of environmental or other liability to a governmental unit under State or federal laws."

38

Problem: Improperly Affecting Purchaser's Obligations

- 363 motions often purport to affect the Purchaser's obligations to comply with applicable environmental laws as the new owner or operator of property. Those obligations are not affected by an asset sale – or by bankruptcy - and this principle is now well-established. *Ohio v. Kovacs*, 469 U.S. 274, 285 (1985); *In re General Motors*, 407 B.R. 463, 508 (S.D.N.Y. 2009). The Government is forced to object on this ground, and typically prevails on the objection, but this concept needs to be clearly stated in 363.

39

The Problem: Purchaser's Obligations

The Proposed Solution

"Nothing in an order approving an asset sale shall be construed to affect any liability to a governmental unit under applicable non-bankruptcy law that any entity would be subject to as the owner or operator of property."

40

The Problem: Eliminating Purchaser's Successor Liability

- Sales routinely include provisions, later approved in the 363 order, that eliminates the purchaser's liability as a successor to the debtor. Nothing in the Code actually authorizes such a non-bankruptcy law result. While the law of successorship is fairly narrow and most arm's length sales would not result in liability in any event, the court lacks authority to eliminate liability by fiat.

41

The Problem: Successor Liability

The Solution

Amend 363 to provide:

(1) Nothing in the order approving a sale shall affect the purchaser's future liability under applicable State or federal law.

(2) The debtor and purchaser may request a determination based on a factual record and pursuant to applicable law that successorship does not result, but may not simply eliminate liability in a factual and legal vacuum.

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Justification

Due Process. Preserves rights of those not before the court.

Certainty. After sale, debtor and purchaser both understand their respective liabilities/obligations to creditors. Purchaser can no longer expect liabilities to be eliminated if the transaction as a matter of law results in mere continuation of the business, or *de facto* merger, or is fraudulent so as to create state law liability. Purchaser cannot assert that a successor liability provision is "an inducement" to the asset purchase if it is no longer authorized.

43

The Problem: Eliminating the Stay/ Statutory Mootness

- The Proposed Solution: Amend 6004 to require good cause shown for any waiver or shortening of the 14-day stay, and to provide that a provision in the purchase agreement or other agreement between the debtor and the purchaser is insufficient to create good cause.

Justification

- Objectors are entitled to their day in court to raise legitimate jurisdictional and substantive issues, as long as they exercise their rights quickly to preserve the value of the assets sold. Depriving them of that right is contrary to well-settled jurisprudence.

45

The Problem: Permits Transferred

- The Proposed Solution:

  Amend 363 to provide:

  "Nothing in an order approving an asset sale shall authorize the transfer or assignment to the purchaser of any license, permit, registration, authorization, or approval issued by a governmental unit except in accordance with applicable non-bankruptcy law governing such transfer or assignment."

  Or

  Amend 363 to allow conditional approval pending the government's authorization to transfer permits.

Justification

- Protection of Public. Government approval of permit transfer serves important legal and public policy purposes.
- No surprises. The purchaser becomes known to the regulator before closing and obtains a clear understanding of the permit requirements, reporting and other obligations, regulatory status of the assets, etc.
- Timing. Government approval of the permit transfer to the purchaser can be expedited.
- Sale Objections Avoided.

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LET THE
DIALOGUE
BEGIN...
48

The Trend Taken to New Limits

- *In re PBBPC*, 484 B.R. 860 (1st Cir. BAP 2013) (asset purchaser not subject to debtor's "experience rating" – used to calculate purchaser's future unemployment insurance tax rates for its *own* operations – because rating was an "interest," of which debtor's assets could be sold free and clear).
- *In re Tougher Industries*, 2013 Bankr. LEXIS 1228 (Bankr. N.D.N.Y. 2013) (same).

25

Pushing Back: A Narrower Reading

- *In re Grumman Olson*, 467 B.R. 694, 702-703 (S.D.N.Y. 2012) ("free and clear" sale order did not prevent plaintiffs from pursuing successor liability tort claims against 363 asset purchaser, based on post-petition injuries suffered while driving a truck made pre-petition because enforcing the order would deny plaintiffs due process)

A Narrower Reading of 363(f)

- *Folger Adam Security, Inc. v. DeMatteis,* 209 F.3d 252, 258 (3d Cir. 2000) (affirmative defenses of setoff/ recoupment are not "interests in property" from which assets were sold free and clear)

- *In re Fairchild Aircraft* , 184 B.R. 910, 917-19 (Bankr. W. D. Tex. 1995) *vacated on other grounds*, 220 B.R. 909 (Bankr. W.D. Tex. 1998) (tort action based on post confirmation injuries caused by defective plane manufactured prior to bankruptcy was not barred against asset purchaser because such an action was not an "interest in" the assets sold; claims are not interests in the property; only *in rem* rights are covered).

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A Narrower Reading of 363(f)

- *Ninth Avenue Remedial Group v. Allis-Chalmers Corp.*, 195 B.R.716, 730-34 (N.D. Ind. 1996) (363 applies to *in rem* interests in property and not CERCLA cause of action that had not arisen during the pendency of the bankruptcy; approval of asset sale "free and clear" does not affect or discharge environmental claims brought later against the purchaser under successor liability theory).

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SHORT SALES BY BANKRUPTCY TRUSTEES: AN EVOLVING TREND

by Jeffrey L. Smoot

> *"The trustee will only sell non-exempt property that has equity... If a debtor owes more on any item of property than what it is worth ... the trustee does not even bother to sell [it]."*
>
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Until recently, chapter 7 bankruptcy trustees did not sell property that had no equity. Homeowners who were "underwater" on their homes could file chapter 7 with a measure of certainty that the bankruptcy trustee would not sell their home. If the home had no equity, there was simply no reason why a chapter 7 trustee would bother trying to sell it. Debtors could expect to stay in the home until it was eventually sold at foreclosure or a loan modification could be worked out with the lender. Recently, however, a growing number of chapter 7 trustees have begun to utilize a combination of § 363 and the short-sale process to attempt to squeeze money out of real estate that would previously have been abandoned because it had no equity and was thus of no apparent value to the bankruptcy estate.

When a debtor files a petition for bankruptcy relief, an "estate" is created. 11 U.S.C. § 541(a). The estate is comprised of all of a debtor's legal or equitable interests in property. In chapter 7 cases, a trustee is appointed to administer the debtor's case, by collecting property of the estate, reducing it to cash, and distributing proceeds to creditors. 11 U.S.C. § 701, 702, 704. The chapter 7 trustee is the sole representative of the

bankruptcy estate, and is charged with the duties of collecting and reducing to money property of the estate. 11 U.S.C. § 704(a)(1); *In re Zavala*, 444 B.R. 181, 189 (Bankr. E. D. Cal. 2011). Included among the chapter 7 trustee's rights is the right to sell property of the estate. Section 363(b)(1) of the Bankruptcy Code provides that the trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate. Property of the estate "consists of all of the interests in property, legal and equitable, possessed by the debtor at the time of filing, as well as those interests recovered or recoverable through transfer and lien avoidance provisions." *Owen v. Owen*, 500 U.S. 305, 308 (1991).

In the spirit of granting honest debtors a "fresh start" through bankruptcy, debtors are entitled to exempt certain assets under applicable state or federal law. For example, as of the writing of this article, in Washington, a debtor can exempt up to $125,000 of equity in his or her "homestead" property (that is, the debtor's actual or declared residence) under state exemption laws or up to $22,975 ($45,950 for joint debtors) under federal exemptions. If there is equity in the debtor's residence that is claimed as a homestead, then the debtor will either get to keep the property because there is no equity value over and above the homestead claim that could be recovered by a trustee through a sale, or at least receive the exempt amount in cash from a sale of the property by the trustee, money that the debtor can use to buy a new homestead property or otherwise keep a roof over his or her head. However, if there is no equity in the debtor's residence, such as when the amount of secured debt against the property exceeds its value (i.e., the home is "underwater"), the debtor, in theory, has no exemption to claim. However, because the property is property of the estate, it is still subject to the control of the bankruptcy trustee, who can sell it if a sale will result in value to the estate, or abandon it if it is of little or no value to the estate.

Traditionally, non-exempt real property that had no equity was abandoned by chapter 7 trustees because there was no benefit to the bankruptcy estate to be gained by selling it. In this topsy-turvy real estate market, this is no longer true. Even though there may be no equity in a debtor's residence, a chapter 7 trustee may still try to sell it for less than the amount of the total secured debt, with the consent of one or more of the secured creditors, who must agree to accept a price that is less than the amount they are owed.

For example, assume the debtor's house is worth $700,000 but is subject to a deed of trust for $750,000. The debtor is unable to claim a homestead exemption because the house is $50,000 underwater; there is no equity to exempt. But the chapter 7 trustee may still try to sell the house, because the trustee has the power to sell any asset of the estate under § 363 of the Bankruptcy Code. For the trustee to sell property that has no equity, a secured creditor must consent to a "short-sale"—a sale that is short of the amount owed.

Why would a chapter 7 trustee bother with a short-sale if there is no equity and the secured creditor would get all of the sale proceeds? Why would a secured creditor want to have the chapter 7 trustee sell the property for less than is owed to the creditor?

What the trustee offers, in exchange for a percentage of the sale price or a buyer's surcharge, is a quick, clean sale of the property with minimal effort on the part of the secured creditor, and without the need to comply with otherwise applicable foreclosure requirements. A trustee in bankruptcy can sell property of the estate free and clear of liens and encumbrances under § 363 within 60 to 90 days. If the secured creditor has to foreclose, it may end up owning the property after a foreclosure sale, after many months of delay (including foreclosure mediation) and considerable expense (which may involve evicting the borrower or occupant, paying insurance, property taxes and utilities, paying for repairs), and still have to sell the property if a third party does not buy the property at the foreclosure sale. On the other hand, if the creditor allows the trustee to do a short-sale, the secured creditor gets cash out of the property without having to worry about the delay, expense, and paperwork of a foreclosure and subsequent eviction. Creditors have realized that a short-sale may be in their economic interests, especially with high-end properties that are expensive to maintain and difficult to sell. And trustees have realized that they can "carve out" value for the bankruptcy estate through the short-sale process.

If, say, the lender agrees to pay the trustee 10% of the sale price on the above example, the trustee would make $70,000 for the benefit of creditors on a short-sale of our hypothetical property for $700,000. Or the trustee may impose a surcharge on the buyer of the property to create value to the estate. For example, using our hypothetical, if the lender agreed to allow a sale for $650,000, the trustee might list it at that price subject to a $50,000 surcharge payable to the trustee in addition to the list price. From those funds, the trustee has to pay real estate commissions and legal and administrative fees, but by doing a short-sale the trustee to obtain a carve-out or buyer's premium can effectively obtain money for creditors of the estate where no equity existed on a straight value-over-liens approach.

Also beneficial to the trustee is that the trustee can earn administrative fees based on the gross sale price of the property. Typically, a chapter 7 trustee earns a flat fee for each case he or she administers, along with a graduated administrative fee based on the value of assets administered by the trustee. For example, assuming a $700,000 sale price, a trustee can earn an administrative fee of approximately $38,000 (according to the formula set forth in Bankruptcy Code section 326(a)). This provides substantial impetus for a chapter 7 trustee to pursue a short-sale of property, although after payment of costs of sale and the trustee's fee, there may be little if anything left for creditors, which is often pointed out by objecting debtors as grounds for denying a trustee's motion to approve a short-sale.

A short sale may even benefit the debtor in certain cases. For example, if the debtor has vacated the property, a short sale will remove the debtor's name from title, alleviating the debtor's responsibility to maintain the property, pay association dues, and similar lingering post-petition liabilities that stay with the debtor, as owner of the property, until the property is conveyed to a new owner. Debtors who wish to finance the purchase of a new home in the future may also benefit from a short sale. Lenders have guidelines for extending credit to borrowers who have derogatory events on their credit, including short sale, foreclosure, and bankruptcy. Under the FHA derogatory credit guidelines, for

example, a chapter 7 debtor can apply for an FHA loan after two years from the date of discharge, and only one year in a chapter 13 case where the debtor has a verified history of one year of timely payments and the trustee's approval, but no sooner than three years following a foreclosure (an in any case, the debtor has also re-established good credit, has stable income, and is otherwise qualified for the loan).

A trustee's right to sell property of the estate is not absolute. The standard for determining the trustee's right to sell property adopted in a majority of jurisdictions is the "business judgment test." *See Equity Sec. Holders v. Lionel Corp. (In re Lionel)*, 722 F.2d 1063 (2d Cir. 1983). Under this test, the trustee has the burden of establishing that there are sound business reasons for approving the proposed sale terms. *In re Bakalis*, 220 B.R. 525, 531-32 (Bankr. E.D.N.Y. 1998); *In re Diplomat Construction, Inc.*, 481 B.R. 215, 219 (Bankr. N.D.Ga. 2012) (citing *In re Schipper*, 933 F.2d 513, 515 (7th Cir. 1991) (stating that sales are an exercise of a fiduciary duty that require an "articulated business justification")). Once adequately established, the trustee's business judgment will generally be given proper deference. *Diplomat Construction*, 481 B.R. at 219. If the trustee can establish that there will be a "meaningful distribution" to creditors, that is a sound business reason for a court to allow a trustee to short-sell a property. Whether a distribution is "meaningful" is determined on a case-by-case basis.

Trustees are not always successful in their efforts to short-sell property. Secured creditors may not be aware of or understand the short-sale process or its advantages, or may have a policy against short-sales, and refuse to allow it. Secured creditors who do allow a short-sale will usually set a target price that the trustee has to obtain for the property before a deal will be done. That price is negotiable, and is usually an amount that puts the secured creditor in a slightly better position than foreclosure would put it. If that price is not met then the short-sale fails. In that case, the asset would be abandoned by the trustee and the lender would eventually foreclose unless a loan modification or some other work-out was agreed to with the debtors. But if a short-sale is approved by the lender and does succeed, the debtors—who expected to be able to stay in their home by either reaffirming the debt, continuing to pay, or at least staying in the home "rent free" until the bank finally gets around to foreclosing—may find themselves looking for a new home much sooner than they expected.

This creative approach to creating estate assets for the benefit of creditors has also created uncertainty in the chapter 7 process for debtors, who can no longer rely on the old rule that trustee's don't sell property that has no equity. Chapter 7 trustees do sell property that has no equity, adding further insult to injury for many honest debtors who have already lost all of their equity through declining real estate values through no fault of their own and now must face a forced sale of their home through the process they thought would protect them from creditors.

Debtors who object to a short-sale can challenge a trustee's efforts to short-sell their home. A trustee has to file a motion to approve a proposed short-sale, and § 363 requires notice and a hearing, giving the debtor an opportunity to object to the proposed sale. A typical objection to a short-sale motion is that the sale will not provide a "meaningful

distribution" to creditors after payment of administrative fees and costs of sale, i.e., that the sale fails the "business judgment" test because the burden and expense of the sale outweigh the potential benefit to the estate, and unsecured creditors will receive only a token distribution after the trustee and real estate broker take their cut. If creditors will not receive a benefit from the proposed sale, there is no business justification for allowing the sale. *See In re Mannone*, 2014 WL 2109926 (Bankr. E.D.N.Y. 2014).

Debtors may also claim the homestead exemption in their residence, even if "underwater," asserting that the exempt "asset" is the debtor's legal right to physical possession of his or her residence until foreclosed and evicted and the ability to control a short sale of the property (i.e., that monetary value is not the only right among the "bundle of rights" protected by the homestead exemption). Debtors are sometimes able to negotiate concessions from the lender in the short-sale process, including an "incentive payment" in consideration of the debtor agreeing to a short sale rather than living "rent free" for several months leading up to a foreclosure sale, and payment of reasonable moving expenses in lieu of the lender having to incur the delay and expense of eviction following foreclosure. A debtor may assert a homestead exemption claim as to those rights or the right to receive economic benefit from a lender; however, the trustee may object to such an exemption claim on the ground that the homestead exemption is not available against monies paid to the estate as "carve-outs" from the lender's sale proceeds or other economic benefits that accrue post-petition on property of the estate.

There is a split of authority on this issue. One line of cases holds that no interests or rights of the debtor exist that may be claimed as exempt in a post-petition short-sale carve-out. *See In re Bunn-Rodemann*, 491 B.R. 132 (Bankr. E.D. Cal. 2013); *In re Baldridge*, 2014 WL 350076 (6th Cir. 2014). The other line of cases holds the opposite: that a debtor may claim as exempt all rights and interests in property including proceeds of a post-petition short-sale carve-out. *See In re Mannone*, 2104 WL 2109926 (Bankr. E.D.N.Y. 2014); *In re Wilson*, 494 B.R. 502, 506 (Bankr. C.D. Cal. 2013).

In *Bunn-Rodemann*, the debtor initially did not claim a homestead exemption because her home was underwater, but amended her schedules to claim an exemption with respect to her "rights and interests" in her residence, specifically her right to "all proceeds, revenues, or concessions conceded or granted by the secured mortgage lender" on the property and her 'intangible personal value contained in the possessory interest" in the property, after becoming aware that the trustee intended to short-sell the property and recover a carve-out from the secured lender. The trustee objected to the exemption claim, asserting that the asset being claimed as exempt did not exist as of the commencement of the case and would not exist unless the trustee marketed and sold the property post-petition. The court sustained the trustee's objection, holding that the debtor did not have, and could not claim an exemption in, the rights and powers of the trustee to sell property of the estate and receive a carve-out from a secured creditor, and that no interests or rights of the debtor existed which could be claimed as exempt.

In *Mannone*, the debtor amended his schedules to claim a homestead exemption in the property where the trustee proposed a short sale that would result in a $20,000 carve-out

from the secured creditor. The court ruled that the price the purchaser is willing to pay, not the debtor's schedules, determined the value of the property, and that the $20,000 was not a carve-out, but an additional $20,000 realized by the debtor's estate from the sale, making the value of the debtor's residence the amount of the mortgage debt plus $20,000, which was exempt.

The *Mannone* opinion is distinguished by the fact that the trustee did not object to the debtor's homestead exemption claim. Apparently recognizing this distinction, the court declined to determine whether to follow *Bunn-Rodemann*, *Baldridge*, and similar cases holding that a carve-out from a short sale is not subject to a debtor's claimed exemption, but pointed to another case which took an opposing view, *In re Wilson*, 494 B.R. 502, 506 (Bankr. C.D. Cal. 2013).

In *Wilson*, the debtor, like most debtors in the same situation, did not believe that the exemption interests available on the petition date were worthy of a declared exemptions because there was no equity to claim as exempt considering value versus liens. However, the court ruled that the debtor was entitled to amended her exemptions to include the exemptions applicable to two properties, where there may be exemption value because the lenders may pay a "tip" to the estate "for the privilege of avoiding foreclosure proceedings and the consumer protection requirements imposed by the State of California." The court ruled that the debtor was entitled to file her amended exemptions, and that she was entitled to the claimed exemptions out of the short-sale carve-out.

> It does not matter how funds are generated by the estate through a Section 363 sale, including if derived from a "tip" from Bank of America or Wachovia so that they will not have to undertake a foreclosure proceeding under California law. Funds derived from these sales are property of the estate and are subject to valid exemptions. The wild card exemption is designed precisely for this purpose—to attach to any estate property that the Debtor designates in her Schedule C form. In this instance, the Debtor has designated funds derived from the sale of the Properties for exemption, and she is entitled to the exemption.

Wilson, 494 B.R. at 506.

This split of authority gives little comfort to debtors facing the possibility of an unwanted short-sale by a chapter 7 trustee, except perhaps cold comfort that they have a mildly persuasive argument against a motion to approve such a sale that will probably be approved in any case if the trustee can show a business justification for the sale, i.e., creditors will receive a "meaningful distribution," whatever that means. Bankruptcy judges within the same judicial district may have differing opinions on this issue, as bankruptcy courts in different districts within the same state clearly do, so it is something of a roll of the dice, which may or may not be worth pursuing depending on the amount at issue, the debtor's intentions, and the debtor's ability to retain possession of the property if the sale is disallowed.

Debtors who want to save their home or recover some equity from a short-sale may certainly claim their "rights and interests" in their homestead property as exempt; they can also certainly expect an objection by their trustee, and a likely ruling by the court allowing the short-sale to proceed. However, as this issue continues to evolve, until there is consensus among courts or the Bankruptcy Code is amended, there will be little certainty or predictability for debtors, their counsel, or trustees in such cases, unless the parties are able to make a deal that provides something for everyone. Just as a trustee can negotiate a carve-out with a secured creditor, so can a debtor negotiate an "incentive payment" with the trustee in exchange for the debtor's cooperation with the short-sale process. A debtor may even be able to negotiate a settlement with the trustee to pay an amount to the estate (usually from exempt property or a post-petition loan) in exchange for the trustee not pursuing a short sale. After all, "these debtor-trustee issues concerning a short sale are steeped in the highest tradition of bankruptcy — what deal can be made that is in everyone's best interest." *Bunn-Rodemann*, 491 B.R. at 137.

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THE ADVANTAGES OF A SHORT SALE IN BANKRUPTCY. IS THE DEBTOR ENTITLED TO AN EXEMPTION?

By
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I. Introduction

A short-sale of real estate is an alternative to foreclosure whereby mortgaged property is sold for less than the amount owed on the mortgage. For a creditor, a short-sale may be preferable to completing a foreclosure and possibly becoming the owner of the property.

In the bankruptcy world, Chapter 7 trustees can work with secured creditors to conduct short-sales of property of the bankruptcy estate, where the creditor agrees to carve out a portion of the sale proceeds for the bankruptcy estate. Recently, some debtors have tried to take advantage of this phenomenon by claiming an exemption in the property to get a piece of the short-sale proceeds. As discussed in this article, the majority of courts addressing this issue have concluded that debtors cannot usurp the short-sale process in this manner.

II. Short Sales in Bankruptcy

A. Trustee's Duties

One of the trustee's primary responsibilities in a Chapter 7 case is to "collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest." Section 704(a)(1) of the Bankruptcy Code (11 U.S.C. § 704(a)(1)). As an officer of the Court and as a representative of the debtor's creditors, the trustee has a duty to achieve the maximum return for the estate for further distribution to creditors. *In re Payne*, 512 B.R. 421, 427 (Bankr.E.D.N.Y. 2014). "Although a Chapter 7 trustee is a fiduciary obligated to treat all parties fairly, [the trustee's]

primary duty is to the estate's unsecured creditors." *Id.* (citations omitted). Indeed, underlying all of a chapter 7 trustee's actions, including decisions about sales of property of the estate, is the fiduciary duty to maximize distribution to creditors. *Id.* (citations omitted).

B. Authority to Sell

To aid the Chapter 7 trustee in accomplishing her goal of collecting money to distribute to creditors, Congress gave her the power to sell property of the estate outside the ordinary course of business under § 363(b)(1) of the Bankruptcy Code, which provides that the trustee "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . .." With the consent of the secured creditors, the trustee can sell the property free and clear of liens. § 363(f)(2). Thus, if a deal is made between the Chapter 7 trustee and the secured creditors, a motion to sell real estate under § 363 would allow the trustee to sell the real estate even where the sale proceeds would be insufficient to satisfy the liens in full. Bankruptcy courts have routinely approved such short-sales. One bankruptcy court stated very recently that it was "unaware of case law which would preclude an undersecured creditor from negotiating with the trustee for a sale in lieu of foreclosure. This is especially true where the sale will yield proceeds for the estate that would not otherwise be available." *Matter of Brown*, 2015 WL 1541423, *5 (Bankr.E.D.Mich.) (April 1, 2015).

C. Meaningful Distribution to Unsecured Creditors

In light of the trustee's duty to maximize distribution to creditors, the deal between the trustee and the secured creditors must provide for a carve-out to the bankruptcy estate that is sufficient to make a meaningful distribution to unsecured creditors in addition to paying the administrative expenses of the estate. *Reeves v. Callaway (In re Reeves)*, 546 Fed.Appx. 235, 241 (4th Cir. 2013). Historically, carve-out agreements have been reviewed under a standard of

heightened scrutiny due to past abuses by trustees who may have been motivated more by their own compensation than by recovery for the benefit of unsecured creditors. *In re KVN Corp., Inc.*, 514 B.R. 1, 7 (9th Cir. BAP 2014). Nevertheless, any presumption of impropriety can be overcome by the recovery of a meaningful dividend for unsecured creditors. *Id.* What constitutes a dividend that is "meaningful" will vary depending on the circumstances of each case.

D. Benefits to Secured Creditor

Several factors could motivate a secured creditor to agree to pay the bankruptcy estate a portion of the proceeds from a short-sale of property by the Chapter 7 trustee. Those factors may include the following:

- Avoiding the time and expense of a state-court foreclosure proceeding including applicable consumer protection procedures;
- Avoiding the risk of becoming the owner of the property through foreclosure and thus taking on the responsibility of (1) evicting the debtor, tenant or squatter, (2) managing the property, (3) paying insurance, property taxes and utilities, (4) employing vendors to secure, repair and maintain the property while it is being marketed and (5) engaging a real estate broker to sell the property;
- Avoiding or reducing risks associated with the questionable validity of the creditor's secured status or the balance owed on the secured debt;
- The secured creditor has other collateral from which to recover payment of the debt;
- Multiple secured creditors with competing priority claims; and
- The real estate can best be marketed through a sale by the bankruptcy estate.

E. Benefits to the Debtor

A Chapter 7 debtor may also realize certain benefits from a short-sale in bankruptcy and therefore may wish to encourage an agreed § 363 sale among the trustee and secured creditors. Possible benefits to the debtor may include the following:

- Payment of priority debts;
- Payment of debts for which co-debtors or guarantors might be liable; and
- Avoidance of a protracted foreclosure case during which the debtor is the owner of the property and liable for HOA dues and zoning violations.

Further, the debtor may negotiate for additional incentives related to the maintenance and marketing of the property. The debtor may want to avoid paying rent for housing and delay incurring moving expenses during the first months of a Chapter 7 fresh start, while the trustee and secured creditors may want the debtor not only to occupy the property, but to do so in a manner that will maximize the short-sale proceeds. Therefore, in addition to no-rent occupancy, the debtor may try to negotiate for a portion of the carve-out (for example, to cover moving expenses) in exchange for cooperating with the real estate broker and marketing efforts, and agreeing to voluntarily move out of the property after the short-sale is completed. See, e.g., *In re Bunn-Rodemann*, 491 B.R. 132, 137 (Bankr.E.D.Cal. 2013).

III. Is the Debtor Entitled to an Exemption?

Some debtors have tried to take advantage of bankruptcy short-sales by claiming exemptions in the property to receive some of the short-sale proceeds. The majority of courts addressing this issue have concluded that debtors cannot claim such exemptions or otherwise cannot usurp the short-sale process in such a manner.

A. No Exemption under Majority View

Both the Fourth and Sixth Circuit Courts of Appeals have determined that a debtor cannot realize any return on a claimed exemption of a carve-out from the proceeds of a short-sale. *See*, *Reeves v. Callaway (In re Reeves)*, 546 Fed.Appx. 235 (4th Cir. 2013); *In re Baldridge*, 553 Fed.Appx. 598 (6th Cir. 2014). Although both *Reeves* and *Baldridge* are unpublished cases and therefore do not constitute binding precedent, they represent the only discussions of these

exemption issues at the Circuit Court level and are the most reliable predictors of how those courts would rule in published cases. *See, Matter of Brown, supra*, at *3-4 and fn 2.

1. *Reeves v. Callaway (In re Reeves)*, 546 Fed.Appx. 235 (4th Cir. 2013)

In *Reeves*, the debtors owned a residence worth $325,000 that was encumbered by a first mortgage in the approximate amount of $195,500 followed by a federal tax lien in the approximate amount of $382,300. Although there was no equity in the property, the debtors claimed a homestead exemption of $60,000 under North Carolina law. The trustee objected to the exemption on the basis that there was no equity in the residence to exempt. The bankruptcy court overruled the objection and determined that the debtors could reserve their exemptions notwithstanding the lack of equity in the residence. The trustee subsequently filed a motion to sell the residence under § 363 pursuant to a carve-out agreement with the IRS whereby 30% of the sale proceeds that otherwise would be paid toward the IRS tax lien would instead be retained by the bankruptcy estate for payment of allowed administrative claims, with any balance to be paid to unsecured creditors. The debtors objected on the basis that the order allowing them to reserve their claimed exemption actually removed the residence from the bankruptcy estate, such that the trustee lacked statutory authority to sell it. The bankruptcy court denied the objection and granted the trustee's motion to sell. 546 Fed.Appx. at 237-39. On appeal, both the district court and the Fourth Circuit affirmed. The Fourth Circuit noted that because the debtors' residence was not subject to an unlimited or in-kind exemption, it remained property of the bankruptcy estate under § 541until it was either abandoned by the trustee or released upon stay relief and sold by the secured creditor. *Id.* at 241. The fact the IRS had agreed to the carve-out had no adverse consequences for the debtors because they were receiving full credit toward their indebtedness to the IRS for the amount paid to the bankruptcy estate under the carve-out. This

arrangement justified the trustee's action in selling the residence as opposed to abandoning it. *Id.* The court concluded that the debtors' exemption of $60,000 was subordinate to the first mortgage lien and the federal tax lien. *Id.* at 241-42. Thus, effectively, there was no value to which the exemption could attach.

2. *In re Baldridge*, 553 Fed.Appx. 598 (6th Cir. 2014)

In *Baldridge*, the debtors claimed residence or homestead exemptions under § 522(d)(1) in the aggregate amount of $21,600. The bankruptcy court disallowed the exemptions because (i) the debtors' interests were subordinated to the two secured creditors' mortgage liens which were not fully satisfied by the short-sale proceeds and (ii) the carve-out in the amount of $28,000 did not constitute equity in the property subject to the debtors' exemptions. On appeal, the debtors argued that their foreclosure-related right of redemption under state law was an equitable interest with value, and the carve-out should be deemed consideration for the surrender of that right of redemption and included as property of the estate subject to their claimed exemptions. The Sixth Circuit disagreed and held that the carve-out, which was recovered by the trustee upon closing the sale of the debtors' property, was not part of the bankruptcy estate and therefore could not be subject to the debtors' exemptions at the time the bankruptcy case was commenced. Further, the court held that the trustee had authority to waive the right of redemption as a condition of the sale. Finally, the court held that inasmuch as the sale proceeds were insufficient to satisfy the obligations owed to the secured creditors, there was no residual equity in the property to which the debtors' exemptions could attach. 553 Fed.Appx. at 598-99.

The following courts have reached the same conclusion regarding debtors' claimed exemptions in short-sale situations:

3. *In re Bunn-Rodemann*, 491 B.R. 132 (Bankr.E.D.Cal. 2013)

In *Bunn-Rodemann*, the bankruptcy court held that control over the debtor's homestead property, as well as the ability to attempt to negotiate a carve-out from proceeds otherwise subject to a creditor's security interest, passed to the Chapter 7 trustee such that the debtor was not entitled to an exemption therein. 491 B.R. at 135-37. The debtor attempted to claim an exemption under California law in any carve-out funds from a short sale of her real estate, arguing that her pre-petition right to negotiate a short-sale and receive concessions from the secured creditor continued after the commencement of the bankruptcy case and could be claimed as exempt as a necessary part of her post-discharge "fresh start." The court disagreed, finding that once the Chapter 7 petition was filed, the debtor no longer had the right or power to conduct a short sale or to "sell her own real estate services" to engage a broker to market and sell the property. *Id.* at 135. Rather, the Chapter 7 trustee obtained the right to sell the property. "It is the Chapter 7 Trustee's labor and estate's expense in working to sell property of the estate which is the subject of the [carve-out]." *Id.* at 136. The court explained that a Chapter 7 short-sale transaction is consistent with the surcharge provisions of § 506(c) because the carve-out "monetize[s] the benefit to the creditor for the estate retaining the property and incurring the cost and expense related to maintaining and selling the Property." *Id.* In reaching its holding, the court also noted that the debtor's claimed exemption ran afoul of California's exemption laws because "the Debtor cannot claim an exemption in the value of the property subject to the creditor's consensual lien." *Id.*[1] The Court concluded that the carve-out funds were not assets in which the debtor could claim an exemption. *Id.*

[1] Notably, Indiana's exemption statute similarly provides that an exemption is not available with respect to property upon which a debtor has voluntarily granted a lien, to the extent of the balance due on the debt secured by the lien. IND. CODE § 34-55-10-2(e); *see also*, *In re Wylie*, 2012 WL 6737495, *1 (Bankr.S.D.Ind. 2012) (December 28, 2012) (Judge Moberly) (debtors could not assert an exemption in real estate that had no equity).

4. *Matter of Brown*, 2015 WL 1541423 (Bankr.E.D.Mich.) (April 1, 2015)

In *Brown*, the bankruptcy court denied the debtor's motion to stay the trustee's distribution of short-sale proceeds pending an appeal of the court's order denying the debtor's claimed exemption in the property that the trustee had sold. In reaching its holding that the debtor had virtually no chance to prevail on her appeal, the court engaged in a thorough analysis of the propriety of the short sale and the inability of the debtor to claim an exemption. The trustee had filed a motion to sell the over-encumbered property based on a carve-out agreement with the secured mortgage creditors. The debtor then amended her Schedule C to claim an exemption in the property, and the court sustained the trustee's objection to the claimed exemption. The court found that the debtor's claimed exemption was deficient because (i) property subject to liens in excess of the value of the property cannot be exempted and (ii) exemptions are subordinate to consensual liens on real property. 2015 WL 1541423 at *3, citing *Baldridge* and *Bunn-Rodemann*. "Consequently, if the amount of the secured debt exceeds the fair market value of the property such that there is no equity, the exemption is lost." *Id.* at *3.

B. Exemption Available under Minority View

The authors of this article found only one case, *In re Wilson*, 494 B.R. 502 (Bankr.C.D.Cal. 2013), in which the court allowed a debtor's claimed exemption in carve-out proceeds from a bankruptcy short-sale. The debtor initially did not claim any exemptions in the two subject properties because they both were "underwater". The trustee negotiated a short-sale of both properties with a carve-out of $36,250. The debtor then filed an amended Schedule C asserting wild-card exemptions in the properties in the total amount of $26,328. The trustee objected to the claimed exemptions on the basis that the debtor could not claim exemptions that did not exist on the petition date. The Court overruled the trustee's objection and held that the

debtor was entitled to exemptions in the total amount of $23,350. *Id.* at 507. The court rejected the trustee's argument that the debtor could not claim exemptions that did not exist on the petition date. The court reasoned that the debtor's exemptions attached to the properties themselves rather than the carve-outs; the carve-outs were simply the means by which the estate was acquiring funds that were subject to the exemptions. *Id.* at 505.

The court in *Brown, supra*, criticized the *Wilson* decision and disagreed with its reasoning. 2015 WL 1541423 at *5. The court in *Brown* stated as follows:

> The *Wilson* court construed the funds which the undersecured creditors agreed to pay to the estate as "property of the estate" which came into the estate post petition, and ruled that Debtor could claim a homestead exemption in the post petition property. That analysis misconstrues the bankruptcy code provisions regarding what constitutes property of the estate (which is determined on the date the petition is filed, pursuant to 11 U.S.C. § 541), the nature of a secured creditor's interest in properly perfected collateral (a secured creditor's claim is secured to the extent that the lien does not exceed the value of the property, pursuant to 11 U.S.C. § 506(a)), and the definition of the debtor's right to assert a homestead exemption (any exemption is subordinate to payment in full of creditor's lien pursuant to 11 U.S.C. § 522(c)(2)).
>
> This Court is not aware of any case law (nor does the *Wilson* court cite any) for the proposition that a debtor is entitled to an exemption paid out of sale proceeds arising from the sale of an undersecured creditor's collateral. The Court is similarly unaware of case law which would preclude an undersecured creditor from negotiating with the trustee for a sale in lieu of foreclosure. This is especially true where the sale will yield proceeds for the estate that would not otherwise be available. *See In re Bunn–Rodemann,* 491 B.R. 132 (E.D.Cal.2013). Such a sale is entirely consistent with the trustee's duties to the estate and does not come at the debtor's expense because the debtor had no equity to exempt on the date the case was filed.
>
> This Court respectfully disagrees with the reasoning of the *Wilson* case.

Id.

The court in *Wilson* appeared to misunderstand the exemption issue, or it simply chose to rule against the trustee, in part because the trustee did not properly assert an appropriate objection. *See*, 494 B.R. at 505 ("The stated arguments by the Trustee in her Objection are

important for what they allege, and what they do not allege.") In addition, the court clearly did not approve of short-sales of mortgaged properties in bankruptcy, discussing the "carve-outs" sought by the trustee as follows:

> What the Trustee really implies is that the lenders, Bank of America and Wachovia, may be willing to carve out a "gratuity" to the estate so that they do not have to proceed with a foreclosure (and undertake all of the new requirements imposed by the State of California with its new foreclosure statutes and consumer protection efforts.) The Court declines to undertake a separate analysis of the bad faith use of the federal bankruptcy system by such actions, except to question whether the Bankruptcy Code was enacted to provide cover for lending entities desirous of avoiding state-imposed consumer protection laws (including the recently enacted mortgage modification assistance requirements by the State of California.)

Id. at 504 fn.1. For these reasons and the reasons set out in *Brown*, the *Wilson* decision arguably should have little weight as precedential authority.

IV. Conclusion

A short-sale of over-encumbered property by a Chapter 7 trustee can provide benefits to the bankruptcy estate, the secured creditors and even the debtor. Under the majority view, a debtor cannot successfully claim an exemption in the carve-out proceeds from such a sale.