

Bankruptcy Overview

Chas Smith and Jeff Lang



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Title 11 of the United States Code

Nine Chapters

Chapter 1 – General Provisions – Definitions; rules of construction; who may be a Debtor; etc.

Chapter 3 – Case Administration – Commencement of case; officers; administration; administrative powers.

Chapter 5 – Creditors, the Debtor and the Estate – Creditors and claims; Debtor's duties and benefits; the Estate.



Title 11 of the United States Code

Nine Chapters – Cont'd

Chapter 7 – Liquidation – Officers & administration; Collection, liquidation, & distribution of Estate; stockbroker liquidation; commodity broker liquidation; clearing bank liquidation.

Chapter 9 – Adjustment of Debts of Municipality – General provisions; administration; the Plan.

Chapter 11 – Reorganization – Officers & administration; the Plan; post-confirmation matters; railroad reorganization.

Chapter 12 – Adjustment of Debts of a Family Farmer or Fisherman with Regular Annual Income - Officers & administration, the Estate; the Plan.

Chapter 13 – Adjustment of Debts of an Individual with regular Income - Officers Administration & the Estate; the Plan.

Chapter 15 – Ancillary and Other Cross – Border cases - General provisions; Access of Foreign Representatives & Creditors to the Court; Recognition of a foreign proceeding and relief; Cooperation with foreign courts and foreign representatives; Concurrent proceeding.

Estates in Bankruptcy

Property of the Bankruptcy Estate vs. Property of the Debtor

Property of the Estate

The filing of a bankruptcy petition creates an Estate in Bankruptcy under § 541.

Property of the Bankruptcy Estate – consists of all the debtor's legal and equitable real or personal property interests that exists at the moment the petition is filed, **PLUS** certain interests acquired after the commencement of the case such as:

- A bequest, devise, or inheritance;
- Real or personal property received in a divorce or settlement agreement;
- As beneficiary of a life insurance policy;
- Proceeds, rents or profits obtained from property of the estate; and
- Property recovered for the estate by the trustee.

Estates in Bankruptcy

Property of the Bankruptcy Estate vs. Property of the Debtor

Property of the Debtor

Property of the Debtor – Consists of property acquired after the petition is filed and not otherwise classified as Property of the Estate. It also includes:

- Property that is exempt under §522;
- Property that is abandoned under §554;
- Property that has re-vested upon plan confirmation under §§ 1129 & 1141 or 1325 & 1327; and
- Property that never becomes part of the estate such as the debtor's beneficial interest in a spendthrift trust.

Automatic Stay

§362 of the Bankruptcy Code provides that the filing of a bankruptcy petition “operates as a stay, applicable to all entities”, of most actions, against the debtor, property of the estate, or property of the debtor, relating to a pre-petition obligation of the debtor.

This includes actions to obtain a judgment, to collect on a judgment, perfect a security interest in property of the estate, and enforce a security interest in property of the estate.

Purpose of Stay

The purpose of the stay is twofold:

1. It allows for a fair and efficient administration of the debtor's estate by preventing one creditor from getting paid before their counterparts; and
2. It provides the debtor with some breathing room by maintaining the status quo until such time as the bankruptcy court can evaluate the debtor's position.

Critical Points about the Automatic Stay:

1. It arises **AUTOMATICALLY**
2. It is a very **BROAD** (applies to all entities).
3. Actual knowledge not necessary.

Length of Stay

- The automatic stay, unless lifted or modified by an order of the court, remains in effect until the sought after property is no longer part of the bankruptcy estate or the case has been dismissed or closed.
- A discharge also operates to lift the stay as to the underlying debt, it is replaced on a permanent basis by the provisions of §524 which give the debtor the ultimate relief sought in bankruptcy.

Length of Stay

Exceptions

1. If a second bankruptcy is filed within one year of a previously filed and dismissed bankruptcy, the automatic stay will terminate 30 days after the date the second petition is filed; and
2. If there were two petitions filed within the previous year, the automatic stay never goes into effect.

See, 11 USC §362(c)(3) and (4).

Underwriting a Stay Length Exception

§362(c)(3) Exception

1. Independently verify that another bankruptcy proceeding was dismissed within the one year period immediately preceding the current filing; and
2. Review the docket of the current bankruptcy proceeding to determine that no action to extend the stay was filed within 30 days of the date the current petition was filed.

Underwriting a Stay Length Exception

§362(c)(4) Exception

If two petitions were filed within the previous year the automatic stay never goes into effect.

- Although no specific order is required, upon the request of a party - presumably a creditor, the Court must enter an Order to that effect.
- NOTE: A similar Order is unlikely to be entered where there was only one prior filing.

Exceptions To The Stay

§362(b) lists 28 types of actions that are made expressly exempt from the effects of the stay. Some of the real estate related exemptions include:

- An act to perfect or to continue perfection of an interest in property. §362(b)(3);
- Foreclosure actions by the Secretary of HUD to foreclose a mortgage or deed of trust insured under the National Housing Act and covering five or more living units. §362(b)(8);
- The creation or perfection of a statutory lien for ad valorem property tax if such tax comes due post-petition. §362(b)(18); and
- An act to enforce a lien on real estate if, within the past two years, a bankruptcy court found the debtor took part in a scheme to defraud creditors by transferring the real estate in question without creditor consent or by multiple bankruptcy filings. §362(b)(20);

ACTIONS AGAINST CO-DEBTORS

General Rule

The protections of the automatic stay DO NOT extend to co-debtors.

Exception: The collection of a co-debtor's consumer debts in a Chapter 12 or 13 (See, §§ 1201 and 1301, respectively)

NOTE: Only lasts until lifted or modified or until case is closed, dismissed or converted to Chapter 7; and § 524(e) prevents the extension of the bankrupt debtor's discharge to the co-debtor.

Cautionary Tale

Permissible actions against co-debtors may violate automatic stay if it involves a “substantial step” toward furthering the creditor's claim against the bankrupt debtor. (See, *In re Ebadi*, 448 B.R. 308 (Bankr. E.D.N.Y. 2011)).

Violating the Stay

Actions taken in violation of the automatic stay are either VOID or VOIDABLE.

- The U.S. Supreme Court determined in 1940 that such actions were void (see, *Kalb v. Feuerstein*, 308 U.S. 433, 60 S.Ct. 343 (1940)) but how about under the current version of the Bankruptcy Code?

From an underwriting standpoint, either result creates a problem that must be addressed either through curative action or declining to insure the transaction.

NOTE: The creditor's subjective good faith in proceeding with the foreclosure (due to lack of notice or actual knowledge of the bankruptcy filings) DOES NOT cure the violation.

ENFORCEMENT by CREDITORS

Enforcement is NOT limited to the debtor

- Courts have recognized the ability of a creditor who is harmed by a violation to bring an action. See e.g., *In re Watson*, 505 B.R. 634 (Bankr. M.D. PA. 2014); and *St. Paul Fire & Marine Ins. Co. v. Labuzan*, 579 F.3d 533 (5th Cir. 2009)
- Rationale - The objective of §362 is the equal treatment all creditors within the same class.

NOTE: Courts have limited those actions to injunctive or other equitable actions rather than allow a suit for money damages.

Duration of Automatic Stay

The stay of acts against property of the estate remains until such property is no longer property of the estate.

Property can be removed from the Bankruptcy estate through abandonment, revesting into the debtor or a third party after a plan is confirmed, creditor exercise of enforcement remedy after lifting the stay, property sales, and the debtor's exercise of exemption rights in fully exempt property.

*Property of the estate abandoned to the Debtor becomes property of the Debtor.

-The automatic stay continues against Property of the Debtor until the earliest of –

- Case Closure
- Case dismissal
- Grant or denial of Debtor's discharge
- Relief from the Stay is granted.

Relief from the Automatic Stay

- The stay may be lifted (terminated, annulled, modified, etc.)
- General grounds for lifting the stay:
 - Cause (such as lack of adequate protection)
 - Where debtor lacks equity in the property, and that property is not necessary for a reorganization.
 - Most frequently utilized by a lender that seeks to foreclose on its real property security after the debtor files bankruptcy (or to complete a foreclosure commenced pre-petition.)

Dealing with Liens

Existing liens secured by property of the estate can be impacted by a variety of provisions under the Bankruptcy Code:

- Abandonment (§554)
- Avoidance (§522)
- Lien Stripping/Cramdowns (§§506 and 1332)
- Sales Free and Clear (§363(f))

Abandonment

One of many tasks confronting a title insurance underwriter when determining whether to insure a real property transaction impacted by a bankruptcy proceeding is analyzing whether the property remains property of the bankruptcy estate.

The creation of the bankruptcy estate, upon the filing of the petition, allows the Court to administratively dispose of various property interests in such a way so they no longer constitute property of the estate

Abandonment is one of the mechanisms through which property is removed from the estate (created upon case commencement (§541)), as part of the administration of the bankruptcy proceeding.

- This is significant from a title underwriting viewpoint since it transfers the ownership or other interests in real property impacted by a bankruptcy filing out of the bankruptcy estate and back to the debtor (most typically).

Abandonment occurs in two ways:

By motion under §554 (a) & (b)

By operation of law (554(c))

Abandonment by Motion

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:

- 1) Burdensome to the estate or
- 2) of inconsequential value and benefit to the estate.

Legal Theory

Underlying Theory: property of the estate that lacks equity or does not have enough equity to cover the cost of marketing and selling same, will not realize any money to distribute to general unsecured creditors such that it is better to get rid of it through abandonment than to administer it.

Remember that bankruptcy is designed to be an orderly process (using Chapter 7 as a reference) whereby the debtor's assets are liquidated, and after paying costs of administration, distributed equitably to the unsecured creditors.

Abandonment by Operation of Law (§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).

- This is significant from a title insurance underwriting standpoint, and requires analysis of the bankruptcy court records of property coming out of bankruptcy, as well as properties that passed through bankruptcy up the chain of title.
- 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.



Judicial Lien Avoidance

Permitted under §522(f)(1)(A) of the Bankruptcy Code.

“the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent such lien impairs an exemption to which the debtor would have been entitled...if such a lien is... a judicial lien

What to Look For

1. The lien for which avoidance is sought must be a judicial lien;
2. An exemption must apply – For example, Look to state’s homestead property exemption; and
3. The judicial lien must impair the exemption

Impairment of an Exemption Right

Simple arithmetic (See §522 (f)(2)(A)):

A judicial lien impairs an exemption right if
the sum of –

The lien PLUS

Other liens on the property PLUS

The permitted exemption amount
exceeds the value of the Property.

Hypothetical

Property Value =	\$245,000
Unavoidable Debt	
1st Mortgage	\$175,000
2nd Mortgage	\$35,000
Tax Lien	\$15,000
Total Unavoidable Debt	<u>\$225,000</u>
Gross Equity	\$20,000
Less Exemption Claimed	\$5,000
Net Equity	\$15,000
Judgment 1	\$2,100
(Subtract from net equity)	<u>\$12,900</u>
Judgment 2	\$17,500
(Subtract from remaining net equity)	-\$4,600

Hypothetical Answer

Judgment 2 is unavoidable to the extent of \$12,900 and avoidable to the extent of \$4,600.

Total of judgment 1 (\$2,100) + unavoidable liens (\$225,000) + exemption (\$5,000) = \$232,100. Since this amount is less than the value of the property (\$245,000), judgment 1 is not avoidable.

Total of judgment 2 (\$17,500) + unavoidable liens (\$227,100) [includes the unavoidable judgment 1] + exemption (\$5,000) = \$249,600. Since this figure exceeds the property value of \$245,000 by \$4,600, \$4,600 of judgment 2 impairs the exemption and is therefore avoidable which leaves the remaining \$12,900 portion of judgment 2 unavoidable.

Underwriting Do's

The court order must conclude:

A) There is impairment; and

B) Expressly identify the lien or liens that are extinguished (preferably by identifying the lienholder and recordation information (Book and Page)).

Underwriting Don'ts

Do not remove a judicial lien as a Schedule B exception unless the court order:

- 1) Specifically finds an impairment;
- 2) Expressly states that the lien is extinguished;
- 3) Provides sufficient information to clearly identify the affected lien(s);
and
- 4) Is a final, non appealable order.

Hypothetical

The Bankruptcy Order states:

It is hereby ordered that the judicial liens impairing the debtor's exemption rights are extinguished.

What do you do?

Lien Stripping

Lien Stripping

Defined

When the amount of the lien exceeds the value of the property securing that lien, the lien is reduced or "stripped down" to the value of the property.

See, §§506 and 1332

Court Decisions

- In a Chapter 7 bankruptcy, the proponents of lien stripping have argued that because Code §506(a) authorizes bifurcating claims into “secured” and “unsecured” components, then Code §506(d) allows the unsecured portion of a first mortgage to be stripped because it is no longer an “allowed” secured claim.
- This position was rejected by the United States Supreme Court in the seminal decision of Dewsnup v. Timm, 502 U.S. 410 (1992).

What about a Second Mortgage?

In the recent Chapter 7 bankruptcy decision, Bank of America, N.A. v. Caulkett, 135 S. Ct. 1995 (2015), the Court ruled that a wholly unsecured second mortgage could not be “stripped off”.

Reasoning

The judge reasoned that a lien “strip-off” was essentially a cram down (removing its lien status altogether) and was distinguishable from the situation presented in the Dewsnup v. Timm decision, which dealt with an undersecured mortgage instead of a wholly unsecured one.

Chapter 13 Lien Stripping

A CHAPTER 13 plan may modify the rights of some, but not all, secured creditors.

MODIFYING A MORTGAGE SECURED ONLY BY THE DEBTOR'S PRINCIPAL RESIDENCE IS PROHIBITED – Code §1322(b)(2) clarifies that “a claim secured only by a security interest in real property that is the debtor’s principal residence” may not be modified.

Early on, many courts ruled that the “unsecured” component of the claim determined under Code §506(a) could nonetheless be “stripped” notwithstanding the prohibition against modification in Code §1322(b)(2).

Ruling

The U.S. Supreme Court ruled on the issue of whether §506(a) permitted “lien stripping” under §1322(b)(2), in Nobleman v. American Savings Bank, 508 U.S. 324 (1993).

The U.S. Supreme Court held that Code §506(a) could not be used as a basis to abrogate the prohibition on stripping the lien of a mortgage secured only by the debtor’s principal residence.

The U.S. Supreme Court noted:

The Debtor can modify certain rights of the holder of mortgage on Debtor's principal residence, but those modification rights are limited (e.g.):

- The Debtors can cure defaults over life of Chapter 13 plan.
- Mortgagee's right to foreclose is checked by the automatic stay.

The court reasoned that to allow a debtor to strip the lien securing its principal residence based on the alleged ambiguity in code §506 would be a fundamental departure from long-standing practice and procedure without any clear guidance from Congress of its intent to take such a radical departure.

What about Wholly Unsecured Liens

There's no definitive answer. The Circuits are split over the issue of whether §506 can be used to strip off a wholly unsecured lien.

Underwriting the Issue

When faced with a Chapter 13 Order that strips off a wholly unsecured lien you must do the following:

1. Determine if the U.S. court of appeals in the applicable federal judicial circuit has held that a Chapter 13 debtor may strip off a wholly unsecured junior mortgage lien;
2. Junior lien creditor was properly served with notice of the Chapter 13 bankruptcy proceeding;

Underwriting the Issue

Continued

3. Junior lien creditor was properly served with notice of the motion to strip off the lien;
 4. The debtor satisfactorily completed the Chapter 13 Plan;
 5. A final discharge order has been entered by the bankruptcy court; and
 6. The time to appeal the discharge order has run.
- * If you are asked to eliminate the lien of a junior mortgage pursuant to a Chapter 13 bankruptcy order or plan, please seek underwriting guidance from your State Counsel.

Chapter 11 lien stripping

A Chapter 11 Plan of Reorganization may modify the rights of holders of secured claims. §1123(b)(5).

This right is not absolute, and there are safeguards in Chapter 11 that protect secured creditors and limit (absent creditor consent) how significantly a secured creditor's rights may be modified in Chapter 11:

Chapter 11 lien stripping

Continued

- adequate protection
- fair and equitable requirement/absolute priority rule (junior class cannot receive anything if senior class dissents and is not paid in full)
- Protections founded in constitutional limitations on “taking” a property right.

Chapter 11 lien stripping

Continued

Chapter 11 contains language protecting holders of mortgages secured by debtor's principal residence that is similar to Chapter 13:

§1123(b)(5) limits modification rights when “a claim secured only by a security interest in real property is the debtor's principal residence” is involved.

- Same limitational language as §1322(b)(2).
- Only applies where the Chapter 11 debtor is an individual.

NOTE

It is more likely that residential mortgage lien stripping will occur in Chapter 13 as Congress provided more exceptions to residential mortgage modifications in Chapter 13 (e.g. 1322(c)(2)), and since Chapter 11 procedures and requirements are more cumbersome.



§1141(c) – Effect of Confirmation

Tricky provision –

- Except as provided for in the plan or order confirming plan, property “dealt with by the plan” is free and clear of all claims and interests of creditors...
- Similar language in §1327(c).
- Lots of litigation here where creditors wake up after the process is completed, finally put all the pieces together, and then realize how significantly their rights have been impacted.

Generally, if the creditor received notice, did not object, the plan was confirmed, and the approval period ran, its too late.

Before Old Republic Title is willing to consider underwriting over a lien stripped or “crammed-down” in Bankruptcy, it must be confirmed that the impacted lien holders had notice, and the extinguishment or other modification of their lien rights was expressly stated in the plan/order confirming plan **IN PLAIN ENGLISH!!**

UNDERWRITING DIRECTIVE

Old Republic Title will not rely on the impact of §1141(c) or 1327(c) alone when it determines whether to recognize an adverse impact to lien status due to a confirmed plan in bankruptcy. Only where the impacted creditor has notice **and** the adverse impact on its lien is plainly disclosed, will we consider insuring the transaction without identifying the lien as an exception.

Plain Disclosure Example

The liens of ABC, records in Book _ & Page __ of _____ County, will be extinguished.

Due to the complexities in this area, when asked to underwrite over a Chapter 11 lien stripping or cram-down, you must first obtain the approval of your State Counsel

§363 Sales Free and Clear of Liens

11 USC §363

§363 (f) of the Bankruptcy Code allows the non-exempt real property to be sold free and clear of existing liens.

- Theory behind allowing such sales
- What happens to the lien?

11 USC §363

Three general categories of sales where sales made free and clear of existing liens may occur:

1. Pre-Confirmation sales that generate enough proceeds to full pay all of the secured creditors;
2. Pre-Confirmation sales that do not generate enough proceeds to full pay all of the secured creditors; and
3. Post Confirmation sales.

Must be based on at least one of the following five elements found in 11 USC §363(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;
2. such entity consents;
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;
4. such interest is in bona fide dispute; or
5. such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Applicable Non-Bankruptcy Law

11 USC §363(f)(1)

- Authorizes sale free of liens and interest when applicable non bankruptcy law permits it.
- Rarely used in connection with real property transactions.

Consent to Sale

11 USC §363(f)(2)

- Authorizes a sale free of liens and interests when the holder of the lien or interest consents to the sale.
- The consent contemplated is the consent to the sale of the asset free and clear of liens and interests, and not merely consent to a sale of the asset.

Sufficient Sale Price

11 USC §363(f)(3)

- Authorizes a sale free and clear of liens when the sale price exceeds the value of all liens on the property.
- Courts are divided on the interpretation of this provision.
 - What exactly is meant by the phrase “aggregate value of all liens”?

Interest in Bona Fide Dispute

11 USC §363(f)(4)

- Authorizes the sale free and clear of liens and interests when such interest is in bona fide dispute.
- Generally, the burden of proof to prove bona fide dispute rests with the trustee, or DIP.

Compelled to Accept a Money Satisfaction

11 USC §363(f)(5)

- Authorizes the sale free and clear of liens and interests when such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.
- Does this provision make the other four provisions irrelevant?
 - See, Clear Channel Outdoor, Inc. v. Knupfer, 391 B.R. 25 (B.A.P. 9th Cir. 2008)

Mixing and Matching § 363(f) Provisions

§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.

- Does that mean that you can use two or more elements in combination to achieve a result that could not be obtained with the use of only one element?

Obtaining the Court Order

Motion must be served on all parties whose interests will be effected.

- A proper analysis requires more than just a review of the various Schedules filed with the Bankruptcy Petition.
- The title records must also be searched and then compared against the Bankruptcy Schedules.

Appeal

Orders to sell property free and clear are appealable

- Period within which to file an appeal is 14 days from the date the Order is entered.
 - What about Orders issued under §363(m)?
 - §363(m) specifically reads as follows:

“reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.”
- Sale of property cannot be reversed on appeal or can it?
 - See, Clear Channel Outdoor, Inc. v. Knupfer, 391 B.R. 25 (B.A.P. 9th Cir. 2008)

Questioned Authority of Bankruptcy Courts

Does the Bankruptcy Court have the jurisdictional authority to issue a free and clear Order when the sales proceeds are insufficient to fully pay all secured creditors? If not, can jurisdiction be conferred a creditor's actions in a bankruptcy proceeding?

- Stern v. Marshall, 131 S. Ct. 2594 (2011);
- Waldman v. Stone, 698 F.3d 910 (6th Cir. 2012);
- In re Bellingham Ins. Agency, Inc., 702 F.3d 553 (9th Cir. 2012); and
- Wellness International Network, Ltd v. Sharif, 727 F.3d 751 (7th Cir. 2013)

Checklist for Pre-Confirmation Sales Free and Clear

1. Review Commitment to determine Parties with liens on real property;
2. Review Bankruptcy Matrix to determine if all parties with liens on real property have been listed as creditors;
3. Determine if all lien holders were given Notice of Motion;
4. Does the Order for Sale specifically reference the 11 USC § 363(f) provision which allows the property to be sold free and clear of liens;

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Checklist for Pre-Confirmation Sales Free and Clear

5. Does the Order for Sale reference a business purpose and/or necessity to sell the property prior to a Confirmed Plan;
6. Determine if the Order for Sale specifically identifies the property being sold;
7. Determine if the Order for Sale establishes a reserve for mechanic's liens (if needed);
8. Determine if the Sale Price is sufficient to fully compensate all secured creditors;

Note: If funds are insufficient, you may have a Stern vs. Marshall issue and further inquiry will be needed.

Checklist for Pre-Confirmation Sales Free and Clear

9. Determine if the 14 Day Appeal Period has run from the date of the Order with no appeals having been filed;
10. If an Appeal has been filed, determine if a Stay of the Order Pending the Appeal has been entered;

Note: If Appeal has been filed but no Stay Pending Appeal – this creates a 9th Circuit Clear Channel issue and an appropriate exception must be taken.

11. Collect all necessary Transfer Taxes. Unless State law specifically authorizes otherwise, payment of transfer taxes is required in a Pre-Confirmation Sale. (See, Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc. 554 U.S. 33, 128 S.Ct. 2326); and
12. Obtain a certified copy of the Order for Sale and record it along with all other necessary transactional documents.

Back Chain Creditors' Rights Issues

Hidden Problem

The 2006 Policy forms all contain an exclusion for creditors' rights issues

- See Section 4 in the Exclusions from Coverage portion of the Owner's Policy and Section 6 in the Exclusions from Coverage portion of the Loan Policy.
 - So what's the concern?

Concern

To understand the concern, you need to read the Policy exclusions closely:

- The Owner's Policy reads: "Any claim, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that the transaction vesting the Title as shown in Schedule A..."
- The pertinent part of the Loan Policy reads: "...that the transaction creating the lien of the Insured Mortgage..."

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Concern

The exact language of the Policy Exclusions only pertain to the specific transaction being insured.

- If the sale of Blackacre from A to B will result in an Owner's Policy in favor of B, the Exclusions from Coverage only pertain to any creditors' rights issues which may arise out of that transaction.
- Issues arising out of the prior sale of Blackacre to A are not excluded.

How Back Chain Issues Arise

Typically arise in the context of a bankruptcy as either:

- A. A Preference under §547 of the Bankruptcy Code; or
- B. A Fraudulent Transfer under §548 of the Bankruptcy Code.

They may also arise under a State's fraudulent conveyance statutes.

Preference Issues §547

§547 gives the Bankruptcy Trustee the power to avoid any transfers made by the debtor within 90 days of the filing of the bankruptcy petition.

- This 90 day “look back window” is extended to 1 year if the transfer is made to what the Bankruptcy Code considers to be an “insider”.
- Transfers made within the appropriate look back window are presumed to be a preference.

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Preference Issues §547

Measuring the 90 day look back period

- Look to date of instrument and date of recording.
- Transactions closed prior to the 90 day window but recorded within the 90 day window could be trouble.
 - 30 day recording window

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Preference Issues §547

4 Elements needed to establish a Preference:

1. The transfer was made to or for the benefit of a creditor;
2. The transfer was made on account of an antecedent debt;
3. The transfer was made at a time when the debtor was insolvent; and
4. The transfer enabled the creditor to receive more than it would have received under a Chapter 7 liquidation.

Fraudulent Conveyance §548

A single transfer can also be challenged as fraudulent conveyance under §548 of the Bankruptcy Code.

- Two types of fraudulent transfers:
 1. Actual Fraud – Requires specific intent; and
 2. Constructive Fraud – Seller received less than reasonably equivalent value and the debtor was insolvent or made insolvent by the transfer.

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Fraudulent Conveyance §548

Look Back Period

- Federal:
 - Two years from the date the Bankruptcy Petition is filed.
- State:
 - Varies from two years to six years.
 - Most states have adopted the Uniform Fraudulent Transfer Act ,which has a 4 year look back period, individual state statutes must be reviewed.

Real World Situations

Deeds in Lieu of Foreclosure

- What was the value of the property on the date of the transfer to the creditor?
 - Was it more than the amount owed on the outstanding debt?
- Mortgage Foreclosures
 - Did the foreclosure result in an equity transfer?
 - BFP v. Resolution Trust, 511 U.S. 531, 114 S.Ct. 1757 (1994);
 - In re Villarreal, 2009 WL 2601298(Bkrtcy.S.D.Tex.)

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Real World Situations

No consideration transfers to a related party or a Special Purpose Entity.

- Need to determine why this was done
 - At the request of the lender
 - For estate planning purposes
 - Transfer of title to avoid creditors.

No consideration transfers accompanied by a non-purchase money mortgage.

Assessing the Risk

Factors to Consider

- The age of the questioned transfer
- Financial wherewithal of the transferee
- Was the transfer made at the request of a lender that is now being insured
- Underlying purpose of the transfer
- Existence of lawsuits, judgments or liens occurring in the same time period as the transfer

Title Exception

If a back chain issue is noted, the following exception must be taken in Schedule B regarding the transfer:

- Any claim which arises out of the transfer from _____ to _____, dated _____ and recorded on _____ in Book _____, page _____, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws.

Appeals

Company's underwriting
position:

**DO NOT INSURE A
TRANSACTION IN
BANKRUPTCY
UNTIL THE APPEAL
PERIOD HAS RUN**

*Final judgments, orders and decrees entered by the Bankruptcy are subject to appeal.

-Includes orders or judgments relating to the sale or other disposition of real estate.

* Appeal time period is 14 days.

* Underwriting tip: the Appeal time period can be extended for up to 21 days. Generally, request for extension must be submitted within the original 14 day appeal period.

* The maximum time for an appeal is 35 days (14 days plus 21 day extension) after the entry of the order or judgment appealed from.

Important exception:

The time for filing an appeal may not be extended if the order authorizes the sale or lease of property under §363 or the assumption or rejection of an executory contract under §365.

Stay Pending Appeal - §363(m)

*Unless an order approving a sale (or lease) of property is stayed pending appeal, the sale is not affected by the reversal or modification of the order on appeal, regardless of whether the purchaser has knowledge of the bankruptcy or the appeal, IF – the sale is to a good faith purchaser.

*Posting a bond is required to obtain a stay pending appeal.



•What is a good faith purchaser?

-There are numerous cases where this issue has been litigated – which in and of itself raises the risk of underwriting in this area.

-Generally, in the absence of collusion, and with adequate disclosure of any connections between the purchaser and the debtor (e.g. insiders of the debtor bidding on the property), good faith purchaser status is found, in the absence of inadequate consideration.

-Adequate consideration has arbitrarily been pegged by the case law at 70% or above the property's FMV.

*Mootness

* Where a stay pending appeal has not been obtained the sale of the property at issue renders the appeal moot.

-However, the *Clear Channel* opinion referenced in the outline reached a contrary conclusion by noting that the propriety of the lien-stripping in an order authorizing a sale free and clear under §363(f) was not moot.

-The court's thorough yet complicated analysis noted that §363(m) only covers sales under sections 363(b) and (c), and not §363(f) [the sale free and clear section];

-As such, the protections under §363 (m) apply to the sale, but not to the lien stripping (free and clear) component.

- This is a complicated area. Contact your title underwriter.



*Shortening of the Time Period for posting a bond

- The time period for posting a bond [generally 10 days] may by order of the court be shortened.

*Shortening of the time period for posting a bond DOES NOT impact the right to appeal or the appeal time period.

*Adhere to this guidance:

The appeal time period should never be disregarded or waived. Old Republic will not insure over an appeal right such that the closing for a transaction we agree to insure must be delayed until after the appeal period has run (including any extensions).

Discharge and Lien Survival

DISCHARGE

Principal Goal and Primary Benefit of Bankruptcy

Extinguishes Debtor's Personal Liability on scheduled, dischargeable debts

- Does not extinguish the obligation
e.g. co-obligors remain liable

DISCHARGE

CONTINUED

Bankruptcy Code Text

- §727(b) provides in pertinent part:

- (b) Except as provided in §523 of this title, a discharge... discharges the debtor from all debts that arose before the date of the order for relief....

- Plain English Translation:

- The discharge “discharges” the pre-petition debts of the Debtor that are not determined to be non-dischargeable under Code §523.



DISCHARGE

CONTINUED

Does the Bankruptcy Code define this central concept?

So what does it mean to “discharge” a debt?

- The discharge extinguishes the Debtor’s in personam (personal) liability for his/her pre-petition obligations.

Impact of the Discharge upon Pre-Petition Liens

The Debtor's Discharge alone does not extinguish valid, pre-petition Liens.

Widely misunderstood

Based upon the view that the discharge extinguishes the debt, and under state law you need a valid underlying obligation to have a valid lien.

Correct View

The Discharge does not extinguish the debt.

Only the Debtor's personal liability is extinguished.

Therefore, a valid underlying obligation technically survives bankruptcy

- State law requirement that a lien must have a valid underlying obligation that it secures is satisfied.

Fundamental Bankruptcy Maxim

Pre-petition liens affecting the Debtor's pre-petition interests in property “ride-through” bankruptcy unless specific action is taken to void, avoid, or remove those liens from the title to the real property.

Resources

- [StarsLink](#)
- [National Bulletins](#)
- [Bankruptcy Primer](#)
- [Webinars](#)
- [Handouts](#)
- [Pacer.gov](#)
- [Law.Cornell.edu](#)
- Dirt@listserv.umkc.edu