PENN ATTORNEYS
TITLE ALERT

DATE: 12/29/05

RE: Title Alert 2005-23—by Keith Pearson, First American Sr. Underwriter Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

Congress recently enacted and President Bush signed The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. While most of the provisions affect parts of the bankruptcy law that do not directly affect title, there are some changes that will affect how we underwrite transactions involving a bankrupt party. A summary of the changes that are of importance to us is listed below. Most of the changes in the law were effective October 17, 2005.

Serial Bankruptcy Filings

If a lien holder obtains a ruling under new Sec. 362(d)(4) that the debtor has committed a scheme to hinder, defraud, and delay the creditor by transfers of the property or multiple bankruptcy filings, the lien holder is entitled to enforce its lien for a period of two years from the date of such order, except that a debtor may in a later case ask for relief from that order because of changed circumstances or other good cause.

New Sec. 362(b)(21) provides that there is no stay preventing enforcement of a lien on real property of a debtor who has had a previous bankruptcy dismissed for willful failure to abide by the orders of the court, or voluntarily dismissed a prior bankruptcy within the last 180 days.

Writs of Possession

New Sec. 362(b)(22) allows enforcement of a writ of possession against a debtor who is a tenant in residential property 30 days after a bankruptcy has been filed, if the writ was obtained prior to the filing of the bankruptcy, unless the debtor is allowed to cure under non-bankruptcy law, and the debtor does cure in that 30 day period.

New Sec. 362(b)(23) allows an eviction action 15 days after the filing by the landlord of a certification that either the debtor, who is a tenant in residential property, is endangering the property, or there is illegal use of controlled substances on the property, unless the debtor challenges the eviction and then the Bankruptcy Court must order eviction.

PLEASE INSERT INTO YOUR *FORMS, POLICIES & PROCEDURES* BINDER

Penn Attorneys Title Insurance Co.

State Headquarters
900 State Street, Ste 320
Erie, PA 16501
814-454-8278 * 800-352-2216

erie@pennattorneys.com

Eastern Pennsylvania Office
New Bridge Center, Ste 317
480 Pierce Street
Kingston, PA 18704
570-288-1108 * 800-929-4024

epro@pennattorneys.com

New Sec. 362(e)(2) provides a stay is terminated 60 days after a request is made by a party in interest unless the Court orders otherwise or delays the time period.

Notice

New notice provisions in Sec. 342 provide that all notices that the debtor must provide must have the last four digits of the taxpayer identification number of the debtor, must be sent with the current account number of the debtor, and to the address designated by the creditor in two prior communications with the debtor, unless the creditor has filed a notice of address to be used in that case. Additionally, any creditor may file with any Bankruptcy Court a Notice of Address to be used by all Bankruptcy Courts or particular Bankruptcy Courts. If these notice rules are not followed, then notice will not be deemed effective.

This will be very important when we are asked to insure sales free and clear of liens in reliance on the order to remove the liens. Unless you are paying off all liens and obtaining releases of the liens from the creditors, OR the creditors in question file a notice address with the Bankruptcy Court in questions, contact your servicing Penn Attorneys office for advice on how to proceed.

Leases and Other Executory Contracts

Sec. 365(b)(1)(A) provides new requirements for a trustee to assume a contract or lease where there are defaults. The trustee and debtor also must surrender the leased premises if the trustee does not assume or reject within 120 days after the order for relief or the date of the entry of an order confirming a plan. This period may be extended by the Court for up to an additional 90 days, not to exceed a total of 210 days.

Homestead Exemption

A debtor may not exempt property that was acquired by the debtor during the 1215 days period preceding the filing, and that has a value in excess of $125,000, unless it was acquired with the proceeds of an exempt homestead in the same state. This section is intended to prevent debtors from taking advantage of state laws, which are more liberal as to homestead exemption amounts by obtaining property in such states and establishing residency shortly before filing bankruptcy.

Fraudulent Transfers

A new 10 year statute of limitations period applies to transfers to self-settled trusts. A new Bankruptcy Code statute of limitations period of two years applies to Fraudulent Transfer claims under Sec. 548 (this does not affect the longer statutes of limitations of state fraudulent transfer laws that a trustee or creditor may avail themselves of which last up to six years). This two year period is effective April 20, 2006.

Property of the Estate-Chapter 11

A new Sec.1115 was added which provides that in a case in which the debtor is an individual, all property and earnings acquired by the debtor prior to closing, dismissal, or conversion of the case are part of the bankruptcy estate. This is the same as the rule for Chapter 13 bankruptcies, which drag into the bankruptcy estate property and earnings acquired by the debtor during the case

The New Bankruptcy Act
Observations on Some of the Provisions Affecting Real Estate

By John C. Murray

John C. Murray practices with First American Title Insurance Company in Chicago, Illinois, and is group chair of the Real Property Division Commercial Real Estate Transactions and Management Group.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("Act"), Pub. L. No. 109–8, 119 Stat. 23, was debated for more than eight years in Congress and constitutes the most extensive revision of the Bankruptcy Code since 1978. The goal of the Act is to streamline the Bankruptcy Code, speed up proceedings, limit abuses (the FBI estimates 10% of filings involve fraud), and "level the playing field." Accordingly, certain provisions of the Act may make restructuring more difficult for many business debtors by forcing them to make decisions faster and pay back more of their debts, and may force some companies to liquidate rather than work out their financial problems. The changes also will limit the flexibility and discretion of bankruptcy courts to extend the time periods granted to debtors to approve or reject leases and formulate a plan. The following comments examine the rationale for some of the changes and the likely effect they will have on the practices of real estate attorneys and title insurers.

Section 101(51B): Single Asset Real Estate

The Act expands the reach of the Bankruptcy Code's special provisions for single asset real estate bankruptcies. Congress enacted streamlined procedures for this type of bankruptcy in 1994 in response to concerns that single asset real estate debtors were filing Chapter 11 cases with little purpose other than to postpone foreclosure under the automatic stay. See 11 U.S.C. § 362(d)(3) (expediting relief from the automatic stay); id. §§ 1121(e), 1125(f) (expediting plan proposal, disclosure, and confirmation stages).

Although the 1994 amendments were widely heralded by Congress and commentators as a victory for secured creditors, they actually did little to protect secured creditors from single asset filings. This lack of protection resulted, in part, because the definition of single asset real estate encompassed only a real estate business operation having less than $4 million in secured debt. The Bankruptcy Reform Act of 1994 provided for the creation of the National Review Commission ("Commission") to provide input from independent experts regarding possible future amendments to the Bankruptcy Code. The Commission consisted of several "working groups," including one on single asset real estate. In October 1997, the Commission issued a formal report of more than 1,300 pages, including recommendations regarding single asset real estate. One of the specific recommendations of the Commission was that the $4 million cap be removed. See 1 *Report of the National Bankruptcy Commission*, at 664 (Oct. 20, 1997), available at http://govinfo.library.unt.edu/nbrc. Congress acted accordingly and revised Bankruptcy Code § 101(51B), "single asset real estate," as follows:

> [R]eal property constituting a single property or project, other than residential real property with fewer than 4 residential units, that generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto . . . .

The amendment to section 101(51B) deletes the former $4 million debt cap that applied to single asset real estate and also excludes a debtor who is a "family farmer."

To qualify as single asset real estate, income must not be derived primarily from business operations at the property. The definition would exclude hospitals, hotels, casinos, golf courses, manufacturing facilities, ranches, and marinas, among others. See, e.g.,

Centofante v. CBJ Dev., Inc. (*In re CBJ Dev., Inc.*), 202 B.R. 467, 471 (B.A.P. 9th Cir. 1996) (holding that full-service hotel does not constitute single asset real estate under Bankruptcy Code § 101(51B) and stating that "the courts consider not only whether the debtor has only one asset but also whether the debtor has employees other than its principals"); *In re CGE Shattuck, LLC*, 1999 WL 33457789 (Bankr. D.N.H., 1999), at *8 ("the operation of the Debtor's golf course does not meet the statutory definition provided by § 101(51B)"); *In re Kkemko, Inc.*, 181 B.R. 47, 51 (Bankr. S.D. Ohio 1995) (a marina is not within the traditional usage of the term single asset real estate); see generally Kenneth N. Klee, *One Size Fits Some: Single Asset Real Estate Bankruptcy Cases,* 87 Cornell L. Rev. 1285 (2002).

It is difficult as a general matter for single-asset real estate debtors to avail themselves of the Bankruptcy Code protections at all (notwithstanding section 101(51B)) because, although such cases are not bad-faith filings per se, courts often dismiss filings by such entities based on bad faith, following the factors set forth in *In re Phoenix Piccadilly, Ltd.,* 849 F.2d 1393 (11th Cir. 1988). These factors include: (1) the debtor has only one asset (the property); (2) the debtor has relatively few unsecured creditors whose claims are small compared to those of secured creditors; (3) the debtor has few employees; (4) the property is the subject of a pending foreclosure and primarily involves a dispute between the debtor and its secured creditor(s); and (5) the debtor's filing was timed to frustrate the legitimate rights and remedies of the secured creditor(s). See *State St. Houses, Inc. v. N.Y. State Urban Dev. Corp. (In re State St. Houses, Inc.),* 356 F.3d 1345 (11th Cir. 2004) (affirming district court's use of *Piccadilly* factors); Robert N.H. Christmas, *Eleventh Circuit Decision Reaffirms Bad-faith Precedent in Single-asset Cases,* Am. Bankr. Inst. J., Feb. 2005, at 32.

Section 101(54): Transfer

The definition of "transfer" is revised to mean (1) the creation of a lien (new), (2) the retention of title as a security interest, (3) the foreclosure of a debtor's equity of redemption, or (4) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing or parting with (a) property or (b) an interest in property.

The major change is the new language stating that, for bankruptcy purposes, the creation of a lien is a "transfer." This is generally in accordance with existing state law. See, e.g., *Bank Midwest v. Lipetzky,* 674 N.W.2d 176, 181 (Minn. 2004) ("the plain and ordinary meaning of 'transfer' includes the grant of a mortgage"). See also *Black's Law Dictionary* (6th ed. 1990), which defines "transfer," when used as a noun, to include

> The sale and every other method, direct or indirect, of disposing of or parting with property or with an interest therein, or with the possession thereof, or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings, as a conveyance, sale, payment, pledge, *mortgage, lien*, encumbrance, gift, security or otherwise. [Emphasis added.]

The new language in Bankruptcy Code § 101(54), stating that a lien is a transfer, is in great measure a reaction to the concerns of the American Land Title Association (ALTA). The ALTA strongly urged that the creation of a mortgage lien or other security interest in real estate be deemed a "transfer" so that mortgage lenders and other lienholders would be exempt from the Bankruptcy Code's automatic stay provisions, when notice of an undisclosed bankruptcy proceeding in another jurisdiction is not a matter of public record in that jurisdiction, and would be able to assert the "good faith purchaser" defense under Bankruptcy Code § 549(c) to the avoidance of such transfers. See American Land Title Association, *Washington Update: New Bankruptcy Bill/McConville Background* (Feb. 2005), available at www.alta.org/washington/news.cfm?newsID=2495. (See also the discussion of the amendment to section 549, below.)

Section 365: Assumption of Leases and Contracts;
Defaults Based on Nonmonetary Obligations

Bankruptcy Code § 365(b)(1)(A) is amended to provide that an unexpired lease may be assumed notwithstanding the existence of a noncurable, nonmonetary default (other than a penalty rate or penalty provision). The lessee must cure a default caused by the failure to operate a nonresidential lease by resuming operation at and after the date of assumption. Also, the lessor is entitled to compensation for the actual pecuniary loss resulting from such failure to operate. As noted by one commentator, "lessors would be well-advised to include liquidated damages clauses in their leases quantifying the damages that would flow from the failure to operate under their nonresidential real property leases." Risa Lynn Wolf-Smith, *Bankruptcy Reform and Nonmonetary Defaults—What Have They Done Now?*, Am. Bankr. Inst. J., July/Aug. 2005, at 6, 35.

Bankruptcy Code § 365(b)(2)(D) is amended to provide that section 365(b)(1) does not apply to a default under a provision relating to any penalty rate or *penalty* provision relating to a default arising from any failure by the debtor to perform nonmonetary lease obligations. Before this amendment, Bankruptcy Code § 365(b)(2)(D) stated that, for the trustee's option to assume a lease or other executory contract entered into by the debtor by curing any defaults, the trustee's obligation to cure such default was inapplicable if the default was a breach of a provision relating to "the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under the executory contract or unexpired lease." This particular language had created an ambiguity that remained unresolved by the courts: did the word "penalty" modify "rate" or "rate and provision"? This distinction is important because the sentence structure raised a legitimate question about whether or not the exception was for penalty rates and provisions for nonmonetary defaults only, or whether the intent was to include penalty rates for monetary defaults as well as penalty provisions for nonmonetary defaults. If the language in Bankruptcy Code § 365(b)(2)(D) constituted an exception for nonmonetary defaults only, the bankruptcy trustee would not be required to cure penalties imposed by default interest rates. The majority of cases hold that the trustee is not required to pay contractual penalty-interest rates *or* pay penalty provisions applicable to nonmonetary defaults, and the amendment to Bankruptcy Code § 365(b)(2)(D) has now ratified that interpretation. See, e.g., *In re Claremont Acquisition Corp., Inc.,* 113 F.3d 1029, 1034 (9th Cir. 1997); *In re Walden Ridge Dev., LLC,* 292 B.R. 58, 67 (Bankr. D.N.J. 2003); *In re Phoenix Business Park Ltd. Partnership,* 257 B.R. 517, 521 (Bankr. D. Ariz. 2001). But these cases are not entirely clear on whether a default interest rate is per se a prohibited penalty. Neither the Bankruptcy Code nor applicable case law defines "penalty."

Bankruptcy Code § 365(d)(4) (Executory Contracts and Unexpired Leases) is amended to extend the time to assume or reject a lease from 60 days (before the amendment) to 120 days (or confirmation of a plan, if earlier). The court can extend this time period for an additional 90 days for "cause" (210 days total), but only the lessor can authorize further extensions, and the debtor-lessee can no longer extend the time to assume or reject leases beyond confirmation of the plan. Shopping center owners successfully lobbied for this 210-day cap, because bankrupt tenants would often receive extensions beyond the 60 days, stretching their decision out for years and preventing maximization of income and financing opportunities. See David J. Rabinowitz, *New Bankruptcy Law Benefits Shopping Center Owners*, Shopping Center Management Insider, July 2005, at 5, available at www.sillscummis.com/downloads/articles/326/2005%20July%20Rabinowitz%20SCMI%20Report.pdf. The result of this amendment likely will be greater lessor leverage and more negotiations between the lessor and debtor-lessee (especially for multi-site tenancies), based on the lessor's goal of occupancy and control as opposed to the lessee's goal of maximizing value and restructuring. But a retail lessee may claim that to determine which locations are profitable and whether a new merchandising plan is working, it needs to monitor sales trends for at least a year and the business must operate during one "heavy selling" season, such as the Christmas holidays. A large retail debtor with many stores now must make an accelerated strategic decision about which stores should be closed and which should remain open. This, in turn, may limit the ability of a retail debtor and its creditors to realize the full value of underperforming below-market leases at unprofitable locations.

Another result of this amendment is that the debtor-lessee may not have sufficient time to sell “designation rights,” which may affect the value of the property. (The debtor’s real estate often is worth more than its business.) The sale of designation rights (which is a relatively new concept and is becoming more common) involves the bankruptcy court’s approval of the sale of the right to sell the assets (usually multiple leases) of the debtor. Designation rights are not specifically provided for or described in the Bankruptcy Code and have developed without a clear statutory underpinning. It is generally argued that the sale of such rights is permitted under Bankruptcy Code § 365(a) (which provides that the trustee has the right to assume or reject unexpired leases), notwithstanding the existence of “ipso facto” or “anti-assignment” provisions in the leases, so long as the leases have first been assumed (see section 365(b)(2)) or under Bankruptcy Code § 105(a) (which permits a court to “issue any order, process, or judgment that is necessary to carry out the provisions of this title”). Recent case law has approved the concept of the sale of designation rights, and these transactions likely will continue. See, e.g., *In re Ames Dep’t Stores, Inc.,* 287 B.R. 112, 118–26 (Bankr. S.D.N.Y. 2002) (strongly endorsing sale of designation rights).

The sale of designation rights must be approved by the bankruptcy court after the provision of timely and adequate notice to all interested parties, with a reasonable opportunity to object. This requires full compliance with the procedural requirements of Bankruptcy Rule 6004 (Use, Sale, or Lease of Property). The court must approve the bidding procedures applicable to the auction of such rights, including any termination payment or overbid protections. The court usually will issue an order confirming that all notice and procedural requirements were complied with; that the property was widely marketed and that the auction was properly conducted and produced the best price for the property; that the sale was in the best interests of the estate; that the purchaser was a non-insider; and that the purchaser has agreed to cure all monetary defaults under the leases and pay all costs and expenses on each of the properties from the closing date to the date of transfer. The court’s order also may state a termination date for the right to designate properties; one year from the date of closing, for example. The court may allow the successful purchaser to transfer properties to itself, to transfer properties to others, or to require the debtor to retain certain properties.

The purchaser of the designation rights pays the bankruptcy estate for the right to direct which leases will be assumed (and assigned) or rejected and pays all the carrying costs of the properties during the bankruptcy proceeding. Debtors and unsecured creditor committees generally favor the sale of designation rights because they can quickly and efficiently monetize a portfolio of leases and bring an immediate (and necessary) cash infusion to the debtor’s estate. But when designation rights are sold (usually at auction), the process is lengthy and delays, postponements, and extensions of time periods are common. As noted above, the amendments to Bankruptcy Code § 365(d)(4) will make it very difficult to consummate the sale of designation rights, and the required approval or rejection of leases, within the new time frame mandated by the Act.

Under Bankruptcy Code § 365(f)(1) (Executory Contracts and Unexpired Leases), shopping center lessors are the beneficiaries of special protections. These special protections recognize the need of shopping center lessors to maintain the proper tenant “mix” to generate customer traffic, the interdependence of the tenants in providing different types of goods and services, and the importance of quickly determining whether the lease will be affirmed, rejected, or assigned by the debtor-lessee. The 2005 amendments clarify the relationship between section 365(f)(1) and section 365(b)(3). Section 365(b)(3) provides that, for defaulted leases in a shopping center, the debtor-lessee’s right to assume or assign such leases is conditioned on a heightened (as opposed to nonshopping center leases, which are covered by Bankruptcy Code § 365(b)(1)) standard for “adequate assurance of future performance.” Under Bankruptcy Code § 365(b)(3), “adequate assurance of future performance” includes assurance of financial condition and operating performance and maintenance of percentage rent, as well as lack of disruption of the tenant mix and compliance with the provisions of the lease, such as radius, location, use, and exclusivity. This subsection prohibits the debtor-lessee from conducting a new or different business or assigning the lease to a lessee that would conduct its business in a manner inconsistent

with the existing permitted uses of the space or the existing lessee mix or theme of the shopping center.

Bankruptcy Code § 365(f)(1) is amended by the Act to provide that the requirements of section 365(b)(3) take precedence over the "anti-assignment" provisions of section 365(f)(1), which permit assignment of a lease notwithstanding any lease provision that prohibits, restricts, or conditions assignment of the lease. Before this amendment of Bankruptcy Code § 365(f)(1), it was possible for a bankruptcy court to find that section 365(b)(3) should be read in conjunction with section 365(f)(1), so that the court would find unenforceable not only shopping center lease clauses that directly prohibit assignability, but also those provisions that are so restrictive in their scope and application that they constitute "de facto" prohibitions on assignment. See, e.g., *In re Rickel Home Centers,* 240 B.R. 826, 832 (D. Del. 1998) (holding that anti-assignment provisions of section 365(f)(1) override protections for shopping-center lessors provided in section 365(b)(3)). Contra *Trak Auto Corp. v. West Town Center LLC,* 367 F.3d 237, 244–45 (4th Cir. 2004).

Section 503(b) (Priority for Administrative Expenses)

This section applies when a nonresidential lease is assumed and later rejected. Section 503(b)(7) is amended to limit the lessor's priority administrative expense claim for rental to two years following rejection of the lease or turnover of the leased premises (excluding penalty provisions or failure to operate), minus sums received from other parties. (Formerly, there was no such limit.) Thereafter, the lessor's claim is unsecured and subject to the section 502(b)(6) cap (the greater of one year's rent or 15% not to exceed three years, of the remaining term). This subsection was enacted to counteract the decreased time frame available to debtor-lessees to assume or reject leases, as provided in the amendments to section 365(d)(4) (see discussion above). An administrative claim is entitled to full payment for each dollar of rent owed by the tenant and is entitled to payment before other claims.

Section 547 (Preferences)

Bankruptcy Code § 547(b) is amended to overturn the "*DePrizio* rule." In *Levit v. Ingersoll Rand Financial Corp. (In re DePrizio),* 874 F.2d 1186 (7th Cir. 1989), and its progeny, courts extended the preference rule from 90 days to a full year for non-insider creditors when the transfers in question nevertheless benefited an insider. (An insider is one who is a principal of, or related to, or affiliated with the debtor. 11 U.S.C. § 101(31)).

The 1994 Bankruptcy Code amendments revised section 550 to prohibit recovery from a non-insider creditor of a transfer made for the benefit of an insider during the extended one-year "look back" preference period applicable to insider transfers. But the transfer could still be *avoided* under Bankruptcy Code § 547, and cases have so held. See, e.g., *In re Williams,* 234 B.R. 801 (Bankr. D. Or. 1999) (upholding claim of trustee that alleged preferential transfer, involving security interest of defendant in debtor's mobile home, was for benefit of debtor's wife, an insider, and that trustee could avoid perfection of security interest under "*DePrizio* rationale").

Bankruptcy Code § 547(b) is amended to provide that a transfer made between 90 days and one year before the bankruptcy filing to an entity that is not an insider, but that results in a benefit to an insider, is recoverable only from the creditor that is an insider and not from the creditor that is not an insider (including a lender to the debtor). This amendment should result in the greater willingness of lenders to permit loan guarantees by insiders of debtors. It also should eliminate "*DePrizio* waivers" in guaranty agreements, which prohibit an insider guarantor from becoming a creditor of the debtor's estate (thus preventing, hopefully, avoidance of the lender's lien). The amendment applies immediately to cases filed on or after April 20, 2005.

Bankruptcy Code § 547(c)(2) is amended to provide that in order to establish the "ordinary course of business" defense, the defendant need only demonstrate that the transfer was in payment of a debt incurred by the debtor in the ordinary course of business of the debtor and such transfer was (1) made in the ordinary course of business of the debtor and the transferee *or* (2) made according to ordinary business terms (not both, as

required before the amendment). This change should avoid the necessity of obtaining expensive and time-consuming expert testimony regarding industry standards.

New Bankruptcy Code § 547(c)(9) provides that preference actions in nonconsumer cases cannot be brought in amounts less than $5,000. Furthermore, section 1409(b) of title 28, United States Code (Venue of Certain Proceedings), is amended to provide that an action to recover a debt (other than a consumer debt) against a non-insider of the debtor that is less than $10,000 must be brought in the district where the defendant resides; and the former $5,000 threshold for recovery of consumer debt is increased to $15,000. This should limit "nuisance" suits by trustees and decrease costs formerly incurred to appear in distant jurisdictions to defend preference actions.

Bankruptcy Code §§ 547(e)(2)(A), (B), and (C) are amended by extending the "safe harbor" statutory period for a secured party to perfect its lien (and obtain immunity from a preference attack by the trustee or debtor in possession) from 10 days to 30 days. Security interests are voidable by a bankruptcy trustee or debtor in possession as preferential transfers if they were perfected within the preference period, and more than the applicable statutory period (formerly 10 days), commencing after the security interest was granted. This change is consistent with the amendment to Bankruptcy Code § 547(c)(3)(B), which extends from 20 to 30 days the period during which the holder of a purchase-money security interest in the debtor's property can perfect its interest and avoid a preference challenge under section 547.

Section 549 (Post-petition Transactions)

Bankruptcy Code § 549(c) is amended to state as follows (the new language is underlined):

> The trustee may not avoid under subsection (a) of this section [which permits a trustee to avoid a property transfer if it occurs after commencement of the case and is not otherwise authorized by the Bankruptcy Code or the court] a transfer of <u>an interest in</u> real property to a good faith purchaser without knowledge of the commencement of the case and for present fair equivalent value unless a copy or notice of the petition was filed, where a transfer of <u>an interest in</u> such real property may be recorded to perfect such transfer, before such transfer is so perfected that a bona fide purchaser of such <u>real</u> property, against whom applicable law permits such transfer to be perfected, could not acquire an interest that is superior to <u>such</u> interest of such good faith purchaser.

Bankruptcy Code § 549 governs post-petition transactions. Section 549(a) provides that a bankruptcy trustee may avoid a transfer of property of the estate made after the commencement of the case that is not otherwise authorized under the Bankruptcy Code or by court action. Section 549(c), however, provides that the trustee may not avoid such a transfer to a good faith purchaser without knowledge of the commencement of the case, when present fair equivalent value has been received by the debtor. The term "purchaser" is defined, in Bankruptcy Code § 101(43), as a transferee of a voluntary transfer (the definition of "transfer" also includes an "immediate or mediate transferee of such a transferee"). But it is unclear whether a mortgage lender qualifies as a purchaser for the purpose of section 101(43).

In *Thompson v. Margen (In re McConville),* 110 F.3d 47 (9th Cir. 1997), the lenders made a mortgage loan to the debtors without specific knowledge that the debtors had filed a Chapter 11 bankruptcy petition shortly after entering into the purchase agreement. The trustee filed a complaint to avoid the lien of the mortgage as an unauthorized post-petition transfer under Bankruptcy Code § 549(a). The lenders argued that the lien could not be avoided because the mortgage was a transfer to them of real property, and they were good faith purchasers without knowledge of the prior bankruptcy filing. The bankruptcy court agreed that the lenders were good faith purchasers, but held that the recordation of the mortgage violated the automatic stay of Bankruptcy Code § 362(a)(4) and that the lenders were not purchasers under the exception (for good faith purchasers for value without knowledge of the bankruptcy petition) created by section 549(c). The lenders appealed to

the district court, which held that the lenders were not “purchasers” within the meaning of section 101(43) or section 549(c).

The lenders then appealed to the Court of Appeals for the Ninth Circuit, which noted that both parties had “vigorously argued that the lien in favor of the Lenders was a transfer within the meaning of the bankruptcy code.” Id. at 49. The court further noted that the trustee had argued for avoidance of the transfer under Bankruptcy Code § 549(a), while the lenders argued that they qualified for the “good faith purchaser” exception under section 549(c). Citing previous cases, the Ninth Circuit held that “whatever the abstract merits of these contentions, we find them both blocked by our precedents . . . which simply hold that the creation of a lien does not transfer property for purposes of § 549.” Id. But see *Gold v. Nat’l City Home Loan Services (In re Hamama)*, 319 B.R. 851, 853 (Bankr. E.D. Mich. 2005) (holding that transfer under section 549(a) took place on date mortgage was delivered to lender and debtor parted with interest in property; recording was not required for mortgage to be valid).

The Ninth Circuit then found that the debtors had violated Bankruptcy Code § 364(c)(2), which prohibits a debtor from obtaining secured post-petition financing without prior bankruptcy court authorization. The court ruled that rescinding the unlawful loan transaction was an appropriate remedy. But the court also considered the equities of the case, noting on the one hand that the parties had stipulated that the lenders had acted in good faith and that the loan enabled the debtors to obtain the property for the benefit of the estate, but that, on the other hand, the lenders had to have known that the debtors’ financial position was precarious and failed to take reasonable steps to determine the debtors’ financial condition. Therefore, based on the equities of the case, the court limited the lenders’ right of recovery from the proceeds of the sale of the property to the amount they had loaned less what they had already been paid on the debt, and granted the lenders a lien on the sale proceeds for that amount.

McConville is an important decision for mortgage lenders. If a mortgage were deemed not to be a transfer for purposes of Bankruptcy Code § 549(a) and the lender therefore was unable to rely on the “good faith purchaser” exception in section 549(c), lenders would be justifiably afraid to make mortgage loans, thereby “chilling” the availability of credit. The risk of subsequent avoidance of the transfer would be substantial in those instances in which the borrower had previously filed bankruptcy in a jurisdiction other than that where the mortgage had been recorded, and such fact had not been disclosed to the lender or the title insurer by the borrower. It is virtually impossible for a mortgage lender or other party who advances funds to the debtor to search for bankruptcy filings in all 50 states at the time of closing. The purpose of Bankruptcy Code § 549(c) is to protect a good-faith innocent party who gives valid consideration to an unscrupulous debtor, when the party has no knowledge of, or reasonable means of determining, the existence of pending bankruptcy proceedings filed by or against the debtor. Bankruptcy Code § 549 has also served to protect the integrity of state recording statutes by protecting lenders, buyers, lessees, and other parties who advance money based on the status of title to the property as disclosed by an examination of the property records in the county where the property is located and such parties are without knowledge of a bankruptcy petition by or against the debtor in another jurisdiction. As the district court noted in *McConville*: “Historically, the section has been invoked when the real estate has been sold in a county outside of where the bankruptcy proceeding is pending.” *Thompson v. Margen* (*In re McConville),* No. C94–3308-FMS, 1994 WL 706325 (N.D. Cal. Dec. 13, 1994), at *2.

Obviously, it is inequitable for the debtor to file for bankruptcy in another jurisdiction, obtain a mortgage loan secured by the debtor’s property after failing to disclose the pending bankruptcy, and then avoid the mortgage lien. It also is inequitable, however, for the lender to make no attempt to ascertain the financial condition of the debtor or inquire whether there are any pending legal actions against the borrower before making the loan. The Ninth Circuit in *McConville,* at least for the courts subject to its jurisdiction, obviated this analysis by holding that the creation of a mortgage lien is not a transfer for purposes of Bankruptcy Code § 549.

The ALTA reacted to this decision by proposing amendments to the Bankruptcy Code that would overturn *McConville* and modify Bankruptcy Code § 362(b) to clarify that a post-petition transfer of real property required to be perfected under Bankruptcy Code § 549(c) (and which would otherwise be immune from attack under section 549) would be a valid transfer of a security interest in real property, and exempt from the Bankruptcy Code's automatic-stay provisions (under section 362(a)), when notice of an undisclosed bankruptcy proceeding in another jurisdiction is not a matter of public record in that jurisdiction. See American Land Title Association, *Washington Update: New Bankruptcy Bill/McConville Background* (Feb. 2005), available at http://www.alta.org/washington/news.cfm?newsID=2495. The ALTA further suggested that Bankruptcy Code § 549(c) be amended to state that it applies to "transfers of interests in real property, including a security interest in real property," when the purchaser has given fair equivalent value without notice of a pending bankruptcy proceeding by or against the debtor and has timely perfected that interest. Id. To further clarify that Bankruptcy Code § 549(c) applies to mortgages and other real estate encumbrances, the ALTA proposed that the definition of "transfer" in Bankruptcy Code § 101(54) be amended by inserting "the creation of a lien." Id.

As amended by the Act, Bankruptcy Code § 549(c) now provides that the transfer of "an interest in" real property to a good faith purchaser for present fair equivalent value and without knowledge of the commencement of the debtor's bankruptcy case cannot be set aside by the trustee or debtor in possession. Also, the definition of "transfer" under Bankruptcy Code § 101(54) (see discussion above) has been amended to specifically include "the creation of a lien." It is hoped these changes will prevent future decisions, such as the Ninth Circuit's ruling in the *McConville* case, that refuse to acknowledge a mortgage lien as a "transfer" and thereby prevent the mortgage lender from asserting the "good faith purchaser" defense provided by Bankruptcy Code § 549(c).

Section 1121 (Period for Filing Plan Under Chapter 11)

Bankruptcy Code § 1121(d)(2) is amended to limit the debtor's exclusivity period to file a plan to 18 months (formerly 120 days); the period for solicitation of acceptances is limited to 20 months (formerly 180 days). Formerly, courts had routinely extended the exclusive-filing date in major cases numerous times for "cause." The court now has no discretion to extend the exclusivity period for "cause" beyond the expiration of this time period.

Extensions of the exclusivity period often were used by debtors as leverage to obtain concessions from lenders and other creditors and as an aid in the negotiation of a plan. The result of this amendment may be more "distressed" sales of property and forced conversions and liquidations.

Expiration of the exclusivity period does not result in automatic dismissal or conversion, or the inability of the debtor to file and seek confirmation of a plan; but it enables other parties in interest to file competing plans (including liquidating plans).

Conclusion

The Act, which contains more than 500 pages of legislation, does not contain any radical changes to the Bankruptcy Code that affect residential and commercial real estate transactions. But it does clarify several issues that were the subject of different interpretations and conflicting federal court decisions. The Act also addresses some of the perceived abuses that were brought to light as the result of the recent filings of the largest business bankruptcies in history (including Enron and WorldCom). Many commentators believe that the Act tilts the playing field in favor of creditors. But the validity of this evaluation remains to be seen, as the same comments were made about previous revisions and amendments to the Bankruptcy Code in 1978 and 1994.