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Real Property for Bankruptcy Attorneys

Many bankruptcy filings include real property, yet the treatment of real property in bankruptcies is frequently misunderstood. This article will explore some common real property issues that arise in bankruptcy.

By Michael E. Kreun

Real Property in the Bankruptcy Estate

The bankruptcy estate includes all of the debtor's legal or equitable interests in property at the time of the bankruptcy filing.¹ Sometimes overlooked real property interests in the bankruptcy estate include remainder interests, fractional interests, and equitable interests. Property in the bankruptcy estate remains in the estate until relevant issues are resolved. This has implications for the automatic stay and, unless the subject property leaves the bankruptcy estate properly, the property could be unmarketable.

The Automatic Stay

When a debtor files for bankruptcy, the filing automatically stays all actions to collect debt against the debtor.² All collection actions must thereafter be made through or with the permission of the bankruptcy court. Penalties for "willful violation" of the automatic stay include actual damages (costs and attorney fees) and punitive damages.³

All proceedings involving the debtor's real property must be put on hold until the property leaves the bankruptcy estate or the creditor has received stay relief from the bankruptcy court. The Eighth Circuit has held that acts in violation of the stay are void.⁴ Some courts allow for retroactive relief from the automatic stay.⁵ However, retroactive relief from the automatic stay should be granted "only sparingly and in compelling circumstances."⁶

Removing Real Property from the Bankruptcy Estate

- *Exemptions:* The homestead exemption is the primary method for the debtor to remove residential real property from the bankruptcy estate. If the real property is claimed as exempt, and no creditors object within the statutory period, the clerk of bankruptcy court will issue a certificate of property claimed as exempt. The certificate

should be recorded in the real estate records to evidence the exemption of the realty from the bankruptcy estate. If the legal description on the property claimed exempt is wrong in the debtor's schedules, corrective action is necessary or the certificate will also be wrong.

- *Abandonment by the Trustee:* If the property is over-encumbered by liens, the trustee may be willing to issue a certificate of abandonment. The certificate can be recorded in the real estate records to evidence the abandonment of the property from the bankruptcy estate.

- *Sale by Trustee:* If the property is not exempt, and there is sufficient equity, the bankruptcy trustee has the ability to sell the property, distribute the net proceeds to unsecured creditors, and take a commission on the sale. Trustees sometimes do this after stripping a defective mortgage from the property.

• *Stay Relief Motion*: A creditor must ask the bankruptcy court to allow the foreclosure or other proceeding to move forward by seeking relief from the automatic stay. If the court grants stay relief, the creditor records the stay relief order in the real estate records. The most common bases for relief from the automatic stay are (1) lack of adequate protection of the creditor's interest by the debtor or (2) the property lacks equity and the property is not necessary for an effective reorganization.⁷ Local rule 9013-3(a) requires the practitioner to give notice of the motion to anyone with an interest in the property.

• *Dismissal of Bankruptcy*: If the debtor fails to file all necessary documentation in the bankruptcy or fails to comply with a reorganization plan, the bankruptcy court may dismiss the bankruptcy. It is possible to obtain and record a certified copy of the dismissal order to evidence the removal of the property from the bankruptcy estate.

• *Closing of the Bankruptcy*: If the property was properly scheduled in the bankruptcy petition, and the trustee does not administer the property, the property is deemed abandoned to the debtor when the case is closed.⁸ When property is abandoned, it is returned to the debtor as though the bankruptcy had not occurred.⁹ Abandonments, once completed, are typically irrevocable.¹⁰ Most courts hold that re-opening a bankruptcy does not nullify the abandonment.¹¹ The trustee has a duty to investigate the value to the estate of scheduled property and to decide whether the property should be administered before the closing of the case.¹² Courts usually have departed from the general rule of irrevocability of abandonment only if a debtor concealed the property from the trustee or where the trustee lacks knowledge, or means sufficient to gain knowledge, of the property's existence.¹³ A certified copy of the bankruptcy schedules and the orders discharging the debtor and closing the bankruptcy can be recorded to evidence the abandonment of the property.

Lien Avoidance

Perhaps one of the greatest ways real property is affected by a bankruptcy filing is by lien avoidance claims. A mortgage holder must quickly record a mortgage to survive bankruptcy attack. Otherwise, if the mortgage debtor files bankruptcy, the automatic stay will operate to prevent recording of the mortgage.¹⁴ It is also imperative that the legal description in the

mortgage be accurate and that the mortgage be recorded in the correct office. Perfecting of the mortgage implicates various types of avoidance claims by the trustee.

• 11 U.S.C. § 544 "Strong-Arm Claim": If the lien is not perfected at the time of the bankruptcy, the bankruptcy trustee has the rights of a good faith purchaser of the property to avoid the lien and sell the property free and clear of the lien. The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of a bona fide purchaser of real property.¹⁵ State law determines whether a lien is perfected at the time of the bankruptcy filing.¹⁶ The bankruptcy trustee is automatically in the position of a bona fide purchaser under state law regardless of the trustee's own knowledge.¹⁷

Most battles under Section 544 involve whether the mortgage or lien was properly perfected under state law. Common mistakes that lead to a Section 544 strong-arm claim include an unrecorded mortgage, an error in the legal description, recording of the mortgage in the wrong office, unsigned or improperly executed

mortgages, and mortgages signed by a party not in the record title (i.e., owned by an LLC, but signed by an individual).

• 11 U.S.C. § 545 Statutory Liens: The trustee may avoid certain statutory liens under 11 U.S.C. § 545. Statutory liens arise solely by force of statute, but they do not include security interest or judicial liens.¹⁸ A common example of a statutory lien is a mechanic's lien. Statutory liens are recognized but only if they are enforceable against a bona fide purchaser and do not become effective simply upon insolvency.¹⁹ The trustee can avoid a statutory lien if the lien first becomes effective on insolvency; the lien is not perfected or enforceable on the date of filing against a bona fide purchaser (whether or not one exists); the lien is for rent; or the lien is for distress for rent.

• 11 U.S.C. § 547 Preferences: A preferential transfer is any transfer of an interest of the debtor for the benefit of a creditor, for an antecedent debt, made while the debtor was insolvent, on or within 90 days before



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the date of filing of the petition (one year if the transferee is an insider). In addition, the transfer enables the creditor to receive more than it would have received if the transfer had not been made and the case were a liquidation case under Chapter 7. In the real property context, a common preference avoidance claim concerns a mortgage that was recorded within 90 days before the bankruptcy filing.

There are several exceptions to the preferential transfer provision under Section 547, including (1) contemporaneous exchanges where a new value is given for the lien or security interest; (2) payments made in the ordinary course of business; (3) the creation of a security interest in property acquired by the debtor for new value where the funds used are, in fact, used by the debtor to acquire the property, and where the security interest is perfected on or before 30 days after the debtor receives possession of such property; (4) bona fide payments of a domestic support obligation are not avoidable; (5) de minimis payments less than \$600, de minimis payments for business debtors totaling less than \$6,425; and (6) payments made according to an alternate repayment plan created by an approved credit counseling agency.

- 11 U.S.C. § 548 Fraudulent Transfers: The trustee (or in some circumstances the debtor) may avoid pre-petition transfers of the debtor's interest in property made within two years prior to filing the bankruptcy or made with actual intent to hinder, delay, or defraud creditors. More importantly, for a creditor who may have benefited from a transfer of property, transfers may be set aside when made for less than reasonably equivalent value, and when the debtor was insolvent at the transfer, or became insolvent as a result of the transfer. The trustee may also use state law to avoid transfers of an interest of the debtor, if avoidable under state law by a creditor holding an unsecured claim.

- 11 U.S.C. § 549 Post-Petition Transactions: Subject to certain exceptions, a trustee or a Chapter 11 debtor-in-possession may generally avoid a transfer of property of the bankruptcy estate that occurs after the commencement of the bankruptcy case. The definition of "transfer" is expansive and includes (1) the creation of a lien; (2) the retention of title as a security interest; (3) the foreclosure of a debtor's equity of redemption; (4) and each mode—direct or indirect, absolute or conditional, voluntary

or involuntary—of disposing of or parting with property or an interest in property.²⁰ A trustee may generally avoid a post-petition transfer of estate property unless the transfer is authorized by the Bankruptcy Code or the bankruptcy court. Court authorization may include (1) a sale;²¹ (2) an abandonment;²² (3) the debtor's exempting property;²³ (4) granting relief from stay to permit a secured creditor to foreclose its collateral;²⁴ and (5) dispositions of property in the ordinary course of business, without notice or a hearing.²⁵

There are certain exceptions to avoidance of post-petition transfers, such as "gap" transfers in an involuntary bankruptcy to the extent of any value given after the commencement of the case in exchange for the transfer;²⁶ transfers to good faith purchasers for present fair equivalent value and without knowledge of the commencement of the case, if a copy or notice of the petition has not been filed in the recording office of the same county where the property is located,²⁷ and where an avoidance action is commenced after the earlier of two years after the date of the transfer sought to be avoided or the time the case is closed or dismissed.²⁸ However, some courts will grant a trustee relief from the statute of limitations under the doctrine of equitable tolling.

Judgments in Bankruptcy

The bankruptcy discharge eliminates any personal obligation to pay debts including mortgage notes and judgments, but it does not automatically eliminate the lien of a judgment. A judgment docketed in the county of the debtor's abstract property homestead remains as much a cloud on the title after a bankruptcy as before, unless the debtor takes action or seeks an administrative discharge to clear the judgment from the homestead.

Curing Mortgage Defaults

11 U.S.C. § 1322(b)(5) allows debtors in a Chapter 13 to cure a default on the mortgage on their primary residence within a reasonable period of time through a confirmed plan. The bankruptcy code does not define a reasonable period of time. In the Bankruptcy District of Minnesota, the reasonable period is presumed to be one year. 11 U.S.C. § 1123(a)(5)(G) allows a debtor in a Chapter 11 to cure a default, including a mortgage default, through a confirmed reorganization plan. This right to cure a default on a mortgage extends even after an entry of judgment of foreclosure in state court, as long as the Chapter 11 bankruptcy is commenced prior to the foreclosure sale. Unlike Chapter 13, there is no presumptive

reasonable period to pay mortgage arrears through a plan.

Conclusion

Real property is present in most bankruptcies. It is important to identify and understand the common issues surrounding real property in a bankruptcy context to protect your client and to ensure continued real property marketability.

¹ 11 U.S.C. § 541.
² 11 U.S.C. § 362.
³ 11 U.S.C. § 362(k).
⁴ In re Vierkant, 240 B.R. 317, 323 (8th Cir. B.A.P. 1999).
⁵ AVierkant at 324.
⁶ Id. citing Soares v. Brockton Credit Union (In re Soares), 107 F.3d 969, 978 (1st Cir. 1997).
⁷ 11 U.S.C. § 362(d)(1) and (2).
⁸ 11 U.S.C. § 554(c).
⁹ See In re McGowan, 95 B.R. 104, 106 (Bankr. N.D. Iowa 1988); 4 Collier on Bankruptcy § 554.02 (15th ed. 1988).
¹⁰ Id.
¹¹ In re Abbott, 183 B.R. 198, 200 (9th Cir. B.A.P. 1995).
¹² In re Tadlock, 338 B.R. 436, 439 (10th Cir. B.A.P. 2006).
¹³ In re Killebrew, 888 F.2d 1516, 1521, fn. 10 (5th Cir. 1989).
¹⁴ 11 U.S.C. § 362.
¹⁵ 11 U.S.C. § 544.
¹⁶ In re Carpenter, 266 B.R. 671, 674 (Bankr. E.D. Tenn. 2001).
¹⁷ In re Keenan, 96 B.R. 197 (Bankr. D. Minn. 1989).
¹⁸ 11 U.S.C. § 101(53).
¹⁹ See 4 Collier on Bankruptcy § 545.01 (15th ed. 1982).
²⁰ 11 U.S.C. § 101(54).
²¹ 11 U.S.C. § 363.
²² 11 U.S.C. § 554.
²³ 11 U.S.C. § 522(b).
²⁴ 11 U.S.C. § 362(d).
²⁵ 11 U.S.C. § 363(c)(1).
²⁶ 11 U.S.C. § 549(b).
²⁷ 11 U.S.C. § 549(c).
²⁸ 11 U.S.C. § 549(d).



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