

TITLE ISSUES

NAVIGATING AROUND BANKRUPTCY SHOALS IN A REAL ESTATE TRANSACTION: BRINGING YOUR CLOSING TO A SAFE HARBOR

WHAT YOU NEED TO KNOW TO SATISFY YOUR TITLE INSURER REGARDING A SALE THROUGH BANKRUPTCY

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With the explosion of bankruptcy case filings in recent years (while the reader would expect to see a footnote here loaded with statistics, the writer, following the lead of Justice Breyer, will avoid footnotes, both because they give an author a chance to digress, and also because of serious doubts about the percentage of footnotes that are actually read), many real estate practitioners find themselves frequently confronting sales through bankruptcy. While even attorneys who have had wide exposure to bankruptcy law can have difficulty with some issues surrounding such a sale, those whose concentration does not include bankruptcy may find the challenges daunting. This article will discuss some of the more common title issues that attend such sales and what is necessary to clear title of these matters.

First, four caveats are in order: (1) not all bankruptcy problems can be covered in an article of this length; (2) there is a distinction between "the law" and title insurance underwriting; although there is an overlap, a title insurer may require more or less than the law requires in order to reach an acceptable risk level; (3) the title clearance procedures outlined below are not set in stone. Flexibility is a key component to title underwriting. Specific fact situations may lend themselves to more liberal underwriting, e.g., there is more risk in waiving a 17-year-old mortgage for \$2000 than a two-year-old mortgage for \$500.00; (4) as always, to the extent that title exceptions can be cleared in advance of closing, everyone benefits, not the least of which is the party seeking the clearance. No attorney wants to be surprised at the closing table with requests by a title insurer for documentation which the attorney does not have or which does not even exist.

I. Types of Bankruptcies

Bankruptcies under three chapters of the Bankruptcy Code (11 U.S.C. para. 101 et seq.; all references below to "Sections" will be to Sections of the code) are the ones that most frequently involve real estate. The first of these is Chapter 7 (Sec. 701 et seq.) which seeks liquidation of the debtor's assets. The second is Chapter 11 (Sec. 1101 et seq.). The debtor in a Chapter 11 proceeding can be an individual, but is most often a corporation. The goal of a Chapter 11 bankruptcy is to provide breathing space for the corporation to reorganize under a "plan of reorganization" and continue in existence, although often "downsized" and under a new name. Finally, a Chapter 13 bankruptcy (Sec. 1301, et seq.) provides certain individ-

uals with a chance to pay back their creditors over an extended period of time, by making periodic payments to a trustee.

II. Statutory Authorization For Sales Through Bankruptcy

Sec. 363 sets forth the basic procedures for sales. These requirements are supplemented by several of the bankruptcy rules (hereafter "Br").

Sec. 363 (c) deals with sales in the ordinary course of business.

Sec. 363 (b) concerns sales not in the ordinary course of business. While the statute makes reference only to a sale by a trustee, under Sec. 1107 a debtor in possession in a Chapter 11 case has most of the powers of a trustee.

Br. 6004 (f) provides that sales not in the ordinary course of business may be by public sale e.g. (auction) or private sale (contract).

Finally, Sec. 363 (f) provides for sales which are commonly referred to as "sales free and clear of liens."

A. Sales in the Ordinary Course of Business

Sales of real property in the ordinary course of business are not common. Such sales usually occur when the debtor is a developer who is selling lots, condominium units, etc. in an ongoing project. The title insurer's main concern in these situations is that the sales are indeed "within the ordinary course of business". To satisfy the insurer of this, the attorney will normally supply a court order (with evidence of proper notice as discussed below) finding that the sales in question are in the ordinary course of business.

B. Sales Not in the Ordinary Course of Business

A sale not in the ordinary course of business is the kind most frequently encountered by the attorney. The purpose of the sale is to bring cash to the estate to pay creditors or administrative expenses of the bankruptcy estate. Such sales are of two types: (1) sales "subject" to liens; and (2) sales "free and clear" of liens.

1. Sales Subject to Liens

A sale subject to liens is best defined negatively, i.e., a sale which is not free and clear of liens pursuant to Sec. 363 (f). A sale subject to liens usually occurs when: (1) there are no liens affecting title

(a rare occurrence in a bankruptcy context); (2) the liens are being paid off at closing pursuant to the bankruptcy court order; or (3) the terms of the sale contract (or auction sale conditions) provide that the buyer is to take title subject to liens.

2. Sales “Free and Clear” of Liens

It is often prudent for the trustee or debtor in possession to sell an asset as quickly as possible before it declines in value. This goal could be hampered by wrangling among the secured creditors as to how much each is owed and what their relative priorities are. If the asset is not sold before these issues are decided, the estate may realize substantially less than if the asset had been sold earlier.

Recognizing this problem, Sec. 363 (f) provides for what are commonly called “sales free and clear of liens.” The relevant portions of the Section provide that:

“The trustee may sell property...free and clear of any interest in such property of an entity other than the estate, only if -

- (1) Applicable nonbankruptcy 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 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.”

Notice that although sales under Sec. 363 (f) are usually referred to as sales “free and clear of liens”, the statute uses the term “interest” rather than “lien”. This allows for application of the statute to more title matters than if it had simply referred to “liens”.

Although the statute does not mandate it, most orders approving sales free and clear of liens provide that the liens shall attach to the proceeds of the sale. The lienholders can then argue about who gets what at a later date.

III. Title Insurance Requirements

There are three main areas of concern to a title insurer when asked to insure title through a bankruptcy sale:

- A. Has a proper notice of sale been delivered to the parties entitled to notice?
- B. Does the order authorizing sale contain sufficient information to allow insurance and closing of the transaction?
- C. Is the proposed insured under the title policy protected from a reversal of the order upon any appeal?

A. Notice of Sale

The title insurer will want copies of the notice and evidence, in the form of certifications, that such notice has been given in the appropriate manner.

Br. 6004 deals with the notice to be given in connection with the sale of property. Br. 6004(a) provides that as to sales not in the ordinary course of business, notice shall be given in accordance with Br. 2002. Br. 2002(a) requires 20 day (unless the court shortens this period) notice of the sale by mail to: “...the debtor, the trustee, all creditors and indenture trustees...”. Br. 9001 (8) defines mail as “...first class, postage prepaid.”

Br. 2002 (c) provides that the notice “...shall include the time and place of any public sale, the terms and conditions of any private sale and the time for filing objections...” It also states that with respect to the sale of real property, the notice is sufficient if it “generally describes” the property. Nevertheless, it is suggested that the notice contain a legal description of the land. Use of only a street address can lead to uncertainty as to what property is being sold, particularly if it is a large commercial tract. Also, if an easement appurtenant to the land is being sold, a description of the easement should be included.

Br. 6004 (c) applies specifically to sales free and clear of liens. This rule requires that a motion to sell property free and clear of liens must be made in accordance with Br. 9014 and shall be “served” on parties having liens and interests in the land. Br. 9014 relates to “contested matters”. It requires that motions be served in compliance with Br. 7004, which sets forth in great detail the methods for serving various types of entities. Br. 7004 should be reviewed when serving such motions.

Br. 6004 (c) also provides that the notice of sale shall include “...the date of the hearing on the motion and the time within which objections may be filed...” Although Br. 6004 (c) does not say so explicitly, it is implicit that the motion state that the sale will be free and clear of liens. In fact, the Advisory Committee notes to Br. 6004 make reference to Br. 9013, which says that the grounds for a motion must be stated “with particularity”. In a “sale free and clear” context, it can be strongly argued that this means the motion must contain reference to the specific subsection (s) of Sec. 363 (f) pertinent to the sale in question.

B. The Contents of the Sale Order

1. Private Sales

The order authorizing a private sale should name the buyer and state that the sale price is fair and reasonable. It should indicate whether the sale is subject to liens or free and clear of liens. (Caveat: prior to closing, discuss with the insurer what exceptions will be waived based on a “free and clear” order. For example, it is not likely that an insurer would waive a building violation case based on such an order). The order should find that the purchaser acted in good faith (this may provide some protection under Sec. 363(m), discussed below).

The order should indicate to whom the proceeds of sale are to be paid. Since most bankruptcy sales are closed through escrow at the title company, the closer looks to the order to determine to whom proceeds should be disbursed. If no disbursement instructions are included in the order, the closer must pay all the proceeds to the grantor in the deed, normally the bankruptcy trustee or the debtor in possession. Such payment may cause problems in that the seller’s attorney may desire to pay taxes, brokers’ commissions, or attorneys’ fees, fund a title indemnity, etc., from the proceeds.

Another problem may occur when the order provides for a sale free and clear of liens. While there may not be enough money to pay all lienholders, the attorney may have promised the first mortgagee, for whose debt there are sufficient proceeds, that it would be paid at closing. Unfortunately, absent a provision in the order to pay this particular creditor, there is no authority for such payment.

To avoid these problems, the order should address the distribution of the sale proceeds. While general language in the order such as “all necessary closing costs may be paid at closing” provides some guidance to the closer, it is preferable to identify the types of payment, e.g., brokers’ commissions, attorneys’ fees, etc., even if an exact amount is not given for each disbursement. In fact, because

last minute adjustments to disbursements are often made, an order that is too specific as to amounts may unduly tie the hands of the closer. Some catchall language at the end of the list of payments in the order can cover last minute contingencies. The court may require a dollar limit above which the catchall provision will not apply.

2. Public Sales

The procedures for public sales are essentially the same as for private sales. The main difference is that the insurer will wish to see two orders: one authorizing the auction and setting forth its terms; and the other confirming the sale to the successful bidder.

C. Appeals

Even when proper notice has been given and a satisfactory order entered, anyone intending to rely on the order, including a purchaser or a title insurer, must be concerned with the right of parties to appeal the order.

The right to appeal a bankruptcy order does not begin when the judge signs the order. The appeal period starts when the order is entered on the bankruptcy clerk's docket. *Stelpflug V. Federal Land Bank of St. Paul*, 790 F. 2d 47, (7th cir. 1986). The standard way of establishing to the insurer that the order has been docketed is to present a copy of the order containing the notation "EOD" (for "entered on docket") and the date of such entry. Br. 8002 provides that the time within which to appeal an order is 10 days from the date of docketing.

Thus, if the closing takes place after such 10 day period, and no appeal, or other motion seeking relief from the order, has been filed within the 10 day period, the insurer will normally delete any exception for a right to appeal.

As to closings within the 10 day period, title insurers are often asked why the possibility of an appeal or even an appeal itself should be of concern in light of Sec. 363(m), which reads in relevant part as follows:

"The reversal or modification on appeal of an authorization...of a sale...does not affect the validity of a sale...to an entity in good faith, whether or not such entity knew of the pendency of the appeal, unless such sale...<was>...stayed pending appeal".

Despite the protective effect of this Section, if the insurer gives an endorsement protecting against an appeal which is pending at closing, or, if after closing an appeal is filed, the insurer would in most cases be obligated to defend against the appeal. However, there are cases in which the insurer might deny liability based on policy provisions, e.g., if the appeal were based solely on alleged collusive bidding by the buyer, the insurer might deny liability under Exclusion 3 (a) of the 1992 ALTA policy, which refers to acts of the insured. If the insurer *is* required to defend an appeal, such defense can be quite costly to the insurer, regardless of the outcome.

Although in other contexts the insurer might consider taking an undertaking from a party to cover these costs, the fact that the seller is a bankruptcy debtor usually means that there is no one available with sufficient assets to back up an undertaking. Nevertheless, there are occasions when the insurer may consider issuing an endorsement which provides some protection to the buyer (and his lender, if any) from a possible or actual appeal. If such coverage is desired, it should be discussed with an underwriter far in advance of the scheduled closing to determine under what conditions it might be available.

Of course, all of the above discussion regarding appeals becomes

moot if a stay of the order approving sale is issued by the court prior to the closing. Formerly, Br. 7062 provided for an automatic ten day stay of an order approving sale. In 1991 the rule was amended to except sales under Sec. 363 from this stay.

Although there is no longer an automatic stay of the order, the court can still grant a stay pursuant to Br. 8005. A motion for stay must be made to the bankruptcy judge. A bond may be required.

The question remains: If a transaction closes within the ten day appeal period and no stay is entered under Br. 8005 prior to closing, is the purchaser protected under Sec. 363(m)? The question was addressed by the 7th Circuit in the case of *In Re. CGI Industries, Incorporated* 27 F. 3d 296 (1994). The court held under the facts of the case that the purchaser was protected.

It is important to note that in CGI, the closing took place four days after the order approving sale became appealable. The court specifically said that it was not ruling on the situation where the closing takes place *immediately* after the order becomes appealable. If the purchaser were to successfully argue that it was protected in this latter scenario, the right to appeal would become meaningless. Such a result would raise serious questions.

Even if a purchaser at such an immediate sale is not protected, how much time must elapse between the date the order becomes appealable and the date of closing so that a purchaser is protected? The court in CGI does not provide an answer. In any event, one should not presume that an insurer would insure a sale to a purchaser within the appeal period without raising a "right of appeal" exception. If an attorney desires to close within this period and obtain an endorsement regarding this exception, discussions with an underwriter should begin as soon as possible to determine the insurer's position on the matter.

IV. Conclusion

As noted above, an article of this length cannot possibly cover all the potential issues surrounding a bankruptcy sale. Such issues include: (1) the proper grantor when title is held by a land trustee; (2) proper marking of public records if one desires to sell free of, or adjust the amount of, real property taxes; (3) notice to unknown parties, such as unrecorded mechanics' liens claimants.

The best service an attorney can render both to the client and himself or herself is to begin a dialogue with the title insurer at the earliest possible date to chart a course which will result in the safe "docking" of the transaction in the most expeditious manner, a goal shared by all parties to the closing.