How To Defend Avoidance Actions In Bankruptcy Litigation

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It's never good to discover a title problem. It's worse when bankruptcy is involved.

I REPRESENT title insurance companies. One of my jobs is to fix title problems. This is often fairly easy to do, particularly if the rights of a third party have not intervened. Unfortunately, if a property owner files bankruptcy, the rights of a third party do intervene. That party is the bankruptcy trustee (or a debtor, acting as a trustee). The trustee can make an easy title problem difficult or impossible to solve. He can be the title insurer's worst enemy.

Consider the case of *Williams v. JP Morgan Chase Bank (In re Stewart)*, 422 B.R. 185 (Bankr. W.D. Ark. 2009). A borrower, Mary Stewart, took out a $105,661 mortgage loan from JP Morgan Chase. The notary who took Stewart's acknowledgment was careless. The notarial certificate contained a blank space where Stewart's name should have been. The certificate referred to the borrower as "he," although Stewart was "a single woman." The Clerk of the Court did not take notice of the error, and recorded the mortgage.

Before Stewart's bankruptcy, this run-of-the-mill error probably would have been easy to fix. After Stewart filed a bankruptcy petition, a solution became impossible. The reason that the problem was unsolvable is that the Bankruptcy Code cloaks the trustee with the rights of a good faith purchaser as of the date of an owner's bankruptcy petition. Armed with these rights, Stewart's

bankruptcy trustee sued to avoid the Bank's mortgage, and won. The Bankruptcy Court ruled that a good faith purchaser could have acquired title from Stewart because the recorded mortgage failed to impart constructive notice under Arkansas Law. Therefore, the Trustee, as a good faith purchaser, could "avoid" the mortgage. The consequence for the Bank was that it lost its secured creditor status, and would receive only a general creditor's share of Stewart's estate. The consequence for the Bank's title insurance company is that the insurer would be obligated to pay a loss.

A bankruptcy trustee has a number of weapons to use to avoid a deed or mortgage granted by a debtor before his or her bankruptcy petition. However, the bankruptcy trustee does not always win. There are a number of ways for a mortgage lender (or other person interested in property) to fight back. This paper provides a battle plan for fighting the trustee.

THE ENEMY AND THE BATTLEFIELD • Proper planning for any battle requires an understanding of the enemy's objectives, the enemy's resources, and a good map of the battlefield. The bankruptcy trustee's objective is always the same: to bring property into the debtor's estate. His resources depend on the condition of the estate. If the estate has few assets at the commencement of a bankruptcy case, the trustee may decide that the available resources will not justify expensive litigation to acquire property unless the prospects for success look pretty good.

The bankruptcy court is the battlefield. The bankruptcy court administers the federal Bankruptcy Code. A fundamental purpose of bankruptcy laws is to give the debtor a financial fresh start. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). Another fundamental policy is "[e]quality of distribution among creditors." *Begier v. IRS*, 496 U.S. 53, 58 (1990). According to that policy, creditors of equal priority should receive pro rata shares of the debtor's property. *Id.*

Kinds Of Bankruptcy

Most bankruptcy cases are voluntary. They begin when a debtor files a Petition with the Bankruptcy Court for relief under a particular Chapter of the Bankruptcy Code. The Chapters encountered most frequently are:

- Chapter 7. A trustee liquidates the debtor's assets in an orderly manner and distributes the proceeds. An individual debtor receives a discharge in most cases;
- Chapter 11. A debtor, usually a business organization, attempts to reorganize under bankruptcy court supervision and remain in business;
- Chapter 13. An individual with regular income seeks approval of a plan adjusting his debts in order to retain more of his property than he could keep in a Chapter 7 bankruptcy. The individual also seeks a discharge.

Consequences Of The Petition

The Petition has important consequences regarding the debtor's property: The Petition:

- Creates an estate. 11 U.S.C. §541. The Petition has the same effect regarding the debtor's real estate as if the debtor had deeded the property to a trustee who was a good faith purchaser;
- Automatically stays suits against the debtor and enjoins creditors from seizing and foreclosing on the debtor's property or property of the estate, in most cases. 11 U.S.C. §362. The stay preserves the estate, enabling the trustee to liquidate the debtor's assets in an orderly manner and preventing some creditors from gaining a greater share of the estate than others. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) provides that no stay arises from a bankruptcy filing if the debtor is ineligible for bankruptcy relief for any of the following reasons: a prior bankruptcy

filing by the debtor was dismissed within the preceding 180 days for willful non-compliance with a court order; a prior bankruptcy by the debtor was voluntarily dismissed after a lift-stay motion was filed; or the court in a prior bankruptcy case entered an order prohibiting the debtor from re-filing. However, a stay goes into effect if the debtor is ineligible for other reasons. *See In re Brown*, 342 B.R. 248 (Bankr. D. Md. 2006) (automatic stay went into effect although debtor was ineligible to file bankruptcy for lack of credit counseling).

The Estate

The estate includes:

- The debtor's legal or equitable interests in property on the petition date;
- Certain community property interests;
- Property inherited or acquired by separation or divorce within 180 days of petition;
- Property the Trustee recovers for the estate.

Estate property does not include property in which the debtor holds legal title but no equitable interest. *E.g., Old Republic Nat'l Title Ins. Co. v. Tyler (In re Dameron)*, 155 F.3d 718, 721-22 (4th Cir. 1998) (funds held in trust by a settlement attorney were not part of the attorney's bankruptcy estate). An individual debtor may remove certain property from the estate if the property is exempt from execution under the Bankruptcy Code or applicable state law; for example, a homestead. Unless the debtor claims the exemption, the property will remain in the estate. *Tavenner v. Smoot*, 257 F.3d 401 (4th Cir. 2001), *cert denied*, 534 U.S. 1116 (2002).

Title To Property Of The Estate

In a Chapter 7 bankruptcy, title to the debtor's property becomes vested in the trustee at the petition date. In a Chapter 11, 12, or 13 bankruptcy, the debtor retains title to the property as "debtor in possession." However, the debtor's retention of title does not mean the debtor may deal with the property as he pleases. The debtor holds the property for the estate, with the same powers and duties as if the debtor had been appointed trustee.

Pre-petition Liens

Liens pass through bankruptcy unless set aside or modified by order of the bankruptcy court. *Johnson v. Home State Bank*, 501 U.S. 78, 82-83 (1991). However, the automatic stay prevents a secured creditor from enforcing the lien after the Petition is filed. A mortgage lender desiring to foreclose must first obtain relief from the automatic stay from the bankruptcy court. The discharge of an individual debtor does not affect liens that attached to the debtor's property before the bankruptcy petition.

THE TRUSTEE ATTACKS: STRONG ARM TACTICS • The Bankruptcy Code's "strong arm" clause, 11 U.S.C. §544, puts a bankruptcy trustee in the same position with respect to real estate title as if he were a bona fide purchaser who bought the property from the debtor on the filing date and simultaneously recorded a deed. *Tyler v. Ownit Mortg. Loan Trust (In re Carrillo)*, 2431 B.R. 692, 696-97 (Bankr. E.D. Va. 2010). Also, the trustee is in the same position as creditor who obtained a judgment against the debtor on the filing date and simultaneously indexed the judgment as a lien on the debtor's real estate. *Id.*

These powers are formidable. For example, the trustee may avoid:

- An unrecorded deed or mortgage the debtor granted before the bankruptcy. *Commonwealth Land Title Ins. Co. v. Miller (In re Project Homestead, Inc.)*, 374 B.R. 193, 199 (Bankr. M.D.N.C. 2007);
- A deed or mortgage where a defective notarial certificate prevents the instrument from imparting constructive notice. *Williams v. JPMorgan*, supra; *Mortgage Electronic Registration Systems v. Agin*, No. 09-CV-10988-PBS, 2009 U.S. Dist.

LEXIS 106872 (D. Mass. Nov. 17, 2009); *In re Crim v. EMC Mortgage Corp.*, 81 S.W.3d 764 (Tenn. 2002);

- A mortgage the lender released by mistake. *In re Anderson,* 324 B.R. 609, 611 (Bankr. W.D. Ky. 2005);
- A mortgage that fails to describe the mortgaged property. *In re Chateau Royale, Ltd.*, 6 B.R. 8, 11 (Bankr. N.D. Fla. 1980);
- A mortgage executed by an entity that did not own the property. *In re: Moreno,* 293 B.R. 777 (Bankr. D. Colo. 2003) (hotel manager signed deed of trust in the name of "Hotel Frisco, LLC," but the manager owned the property in her individual name).

Defenses To Strong Arm Suits

There are several ways to defend against strong arm suits. These are discussed below.

Curative Statutes

Some states have adopted statutes that waive technical defects in a deed or mortgage if the recording office lodged the instrument in the public records for the purpose of imparting constructive notice. Examples:

- D.C. Code §42-403 (formal defects waived if no challenge within six months after recordation);
- Ind. Code Ann. §32-21-4-1 (a recorded instrument imparts constructive notice even if not properly acknowledged). *See Miller v. LaSalle Bank Nat'l Ass'n,* 595 F.3d 782, 785 (7th Cir. 2010);
- Ky. Rev. Stat. Ann. §382.270 (defectively acknowledged instrument lodged for record imparts constructive notice);
- Tenn. Code §66-24-101 (e) and (f) (an instrument, if registered, imparts constructive notice notwithstanding a defective acknowledgment);
- Virginia Code §55-106.2 (writing presumed in proper form after recorded for three years) and Va. Code Ann. §17.1-223 (writing accepted for record and spread on the deed books is deemed validly recorded for all purposes). *See Tyler*, supra, at 701 (holding the second statute controlled because it was later in time).

Equitable Subrogation

Equitable subrogation "allows a person who pays off an encumbrance to assume the same priority position as the holder of the previous encumbrance." *Taxel v. Chase Manhattan Bank (In re Deuel),* 361 B.R. 509, 517 (B.A.P. 9th Cir. 2006), *aff'd,* 594 F.3d 1073 (9th Cir. 2010), *cert. denied*, 2010 U.S. LEXIS 6394 (U.S. Oct. 4, 2010). A lender with a defective mortgage will often invoke the subrogation doctrine to assume the lien priority position of a previous mortgage lender. Some states are more liberal than others in permitting subrogation. *Compare G.E. Capital Mortgage Servs., Inc. v. Levenson*, 657 A. 2d 1170 (Md. 1994) (neither negligence nor constructive notice should be material to a subrogation claim), *with Centreville Car Care, Inc. v. North American Mortg. Co.*, 559 S.E.2d 870 (Va. 2002) (negligence of plaintiff's title examiner militated against subrogation).

In the bankruptcy context, subrogation may be problematic:

- *In re Deuel* denied subrogation to a mortgage lender because, under California law, a bona fide purchaser from the debtor would prevail over a lender seeking subrogation. The mortgage to which Chase Manhattan Bank sought to be subrogated had been released of record before the debtor's bankruptcy petition;
- *In re Reasonover,* 236 B.R. 219 (Bankr. E.D. Va. 1999), *remanded*, 2000 U.S. App. LEXIS 33672 (4th Cir. Dec. 22, 2000), *opinion on remand*, 2001 Bankr. LEXIS 2109 (Bankr. E.D. Va., Apr. 16, 2001), held that a lender's subrogation claim could be viable if the previous encumbrance had not been released of record because the bankruptcy trustee would be on notice of the possible prior encumbrance; however, there

can be no subrogation to a prior encumbrance that has been released of record. *Accord Miller*, supra, 374 B.R. at 205.

Trustee's Constructive Notice

Even if a deed or mortgage is defective, the owner or lender might still be able to prevail against a trustee's strong arm claim if some other document in the land records put the trustee on inquiry of the defective instrument. *In re BowlNebraska,* 2010 Bankr. LEXIS 1908 (B.A.P. 8th Cir. July 1, 2010) (notice of foreclosure recorded before debtor's petition put trustee on inquiry of defectively acknowledged deed of trust); *In re Hedrick*, 524 F.3d 1175 (11th Cir. 2008), *cert. denied*, 129 S.Ct. 631 (2008) (unreleased prior security deed on debtor's property put trustee on inquiry that debtor might have refinanced with a subsequent, defective security deed).

Constructive Trust

Arguments for imposing a constructive trust on the debtor's property rarely succeed in the bankruptcy court:

- In *Miller,* supra, the purchasers of affordable housing had gone to closing and paid the purchase money, but the deeds had not been recorded. The bankruptcy court refused to impose a constructive trust on the homes in favor of the purchasers;
- *XL/Datacomp, Inc. v. Wilson (In re Omegas Group, Inc.),* 16 F.3d 1443 (6th Cir. 1994), held that a bankruptcy court may recognize constructive trust only when the constructive trust was decreed before the bankruptcy;
- *But see In re General Coffee Corp.,* 828 F.2d 699, 700 (11th Cir. 1987), *cert. denied*, 485 U.S. 1007 (1988) in which a constructive trust claimant prevailed over the debtor in possession because, under Florida law, a constructive trust arises when the acts giving rise to the constructive trust occur, not when the constructive trust is decreed.

Debtor-In-Possession's Or Trustee's Actual Knowledge Of Mortgage

Occasionally a mortgage lender will respond to strong arm attack by adducing evidence that the trustee or debtor in possession had actual knowledge of the lender's mortgage, and arguing that this actual knowledge deprives the trustee or debtor in possession of good faith purchaser status. This argument often fails because the trustee's strong arm powers are "without regard to any knowledge of the trustee or of any creditor." 11 U.S.C. §544(a). The argument has succeeded, but only in rare instances:

- In *Deuel*, Chase Manhattan Bank argued that the debtor in possession, Ms. Deuel, was on notice of the Bank's unrecorded mortgage because she listed the mortgage in schedules filed simultaneously with her petition. The Ninth Circuit rejected this argument because the debtor in possession, acting as trustee, has the rights of a hypothetical bona fide purchaser. As the *Deuel* court put it, in applying 11 U.S.C. §544 (a), "we are talking about a metaphysical and not a real person." *Deuel*, supra, 594 F.3d at 1077. The 9th Circuit also provided a practical rationale for its ruling: "if schedules could defeat the trustee's status as a bona fide purchaser..., a debtor could use simultaneous filing of petition and the schedules to favor one creditor over others." *Id.* at 1078;
- *Deuel* had to distinguish itself from *Briggs v. Kent (In re Professional Investment Properties of America),* 955 F.2d 623 (9th Cir. 1992), *cert. denied*, 506 U.S. 818 (1992), which held that a creditor's involuntary petition against the debtor put the trustee on notice of an unrecorded deed of trust mentioned in the creditor's petition. The *Deuel* court refused to consider whether *Professional Investment* had been correctly decided, but

instead held that *Professional Investment* would not apply to a voluntary bankruptcy. *Deuel,* supra, 594 F.3d at 1078;

- *Pyne v. Hartman Paving, Inc. (In re Hartman Paving, Inc.),* 745 F.2d 307 (4th Cir. 1984), held that a debtor's actual knowledge of a defectively-recorded deed of trust precluded the debtor in possession from avoiding the deed of trust. *Hartman Paving* has been questioned, criticized, and ignored, but never overruled. *See Wilson v. Moir,* 2006 Bankr. LEXIS 1001 (Bankr. E.D. Va. 2006).

Be Pragmatic:
Make A Deal With The Trustee

Opportunities may arise to settle a strong arm suit when a mortgage lender would become the dominant unsecured creditor if the trustee avoided the mortgage. The following terms might appeal to the trustee: the trustee dismisses the strong arm suit, allowing the lender to keep its mortgage; and the lender pays the trustee enough to cover administrative expenses and to fund a reasonable dividend to unsecured creditors. Any settlement would be subject to bankruptcy court approval.

Bankruptcy Statute Of Limitations

This is covered in a separate section below.

Defenses To Recovery

If an avoided transaction has transferred a possessory interest in real estate to someone other than the debtor, the trustee must "recover" the property from that person or his successor in order to bring the property into the estate. 11 U.S.C. §550 governs recovery. Good faith purchasers from the debtor have defenses to recovery suits. A separate section below covers these defenses.

Suits To Avoid Preferences

The Bankruptcy Code permits the trustee to avoid preferences. A preference is a pre-petition transfer of the debtor's property:

- To or for the benefit of a creditor;
- To pay an antecedent debt;
- Made while the debtor was insolvent;
- Made on or within 90 days before the date of the petition (or between 90 days and one year if the transfer was to an "insider"); and
- That enables the creditor to obtain more than the creditor's share of a Chapter 7 liquidation of the debtor's estate.

11 U.S.C. §547(b).

If a borrower gives a mortgage to secure a previously outstanding loan from his bank, the transaction would be a preference if:

- The borrower was insolvent when he granted the mortgage;
- If the borrower filed bankruptcy within 90 days after granting the mortgage; and
- The mortgage enabled the bank to obtain more than the bank would have received as a general creditor in a Chapter 7 bankruptcy.

The effect of avoidance is to convert a creditor's claim secured by property of the debtor to an unsecured claim against the estate. *In re Hedrick,* supra.

The preference definition reaches beyond the lender who asks for collateral to shore up a troubled credit. Sometimes a delay in recording will turn a run-of-the-mill mortgage loan into a preference. The trustee may contend that a mortgage secures an "antecedent debt" if recordation of the mortgage was not "substantially contemporaneous" with the funding of the loan. 11 U.S.C. §547 (c)(1) provides that the trustee may not avoid a transfer to the extent it was, "(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and (B) in fact a substantially contemporaneous exchange; ...."

To determine whether a transfer for "new value given" is "substantially contemporaneous" with the giving of new value, one must determine when the transfer occurred. A transfer of real estate occurs under 11 U.S.C. §547 when the transfer is "perfected" against the claims of a bona fide purchaser. 11 U.S.C. §547 (e). Under the laws of most states, a deed or mortgage cannot be perfected until the settlement company records the instrument. If recordation of a mortgage takes place after the loan is funded (as frequently occurs), the debt arguably is antecedent to the security interest granted by the mortgage.

Congress reduced section 547's risks to mortgage lenders by enacting a 30-day relation back period for recording mortgages, such that the mortgage is deemed to have been granted contemporaneously with the loan funding if recorded within 30 days. *Id.* However, if a mortgage is not recorded within the 30-day period, the trustee may be able to avoid the mortgage as a preference if the borrower files a bankruptcy petition within 90 days after recordation of the mortgage. In the case of a purchase money mortgage, the relation back period begins on the date the debtor takes possession of the property. As will be discussed, there is a split of authority regarding whether the 30-day relation back period constitutes a safe harbor or a deadline.

The problem with delayed recordings grew particularly troublesome in Michigan because of delays in county recording offices. Settlement agents would deliver deeds and mortgages to the register of deeds, but the register would not process them within the 30-day relation back period. Once trustees found out about this, the litigation floodgates opened. The floodgates closed when a bankruptcy court ruled that instruments would be deemed registered when delivered to the recording office in proper form with a check for the registration fee, even if an instrument languished for months in the "bin" of instruments awaiting registration. *In re Schmiel,* 362 B.R. 802, 809 (Bankr. E.D. Mich. 2007); *In re Pankey,* 373 B.R. 19 (Bankr. E.D. Mich. 2007), *rev'd on other grounds,* 392 B.R. 710 (E.D. Mich. 2008). The registration delay in *Schmiel* was 96 days. *Schmiel,* supra, 362 BR at 809. The cases below illustrate how bankruptcy trustees have used Section 547 to avoid mortgages:

- A refinancing mortgage recorded within 90 days before the borrower's bankruptcy petition, but after the end of the relation back period (then 10 days, now 30 days) was avoided as a preference. *Collins v. Greater Atl. Mortgage Corp. (In re Lazarus),* 478 F.3d 12, 15 (1st Cir. 2007). *But see In re Hedrick,* supra, 524 F.3d at 1186;
- A foreclosure sale under a defective mortgage is a preference if the sale occurs within 90 days before the borrower's bankruptcy petition. *In re Jones,* 226 F.3d 917 (7th Cir. 2000).

Defenses to Suits To Avoid Preferences

There are several defenses to suits to avoid preferences. These are discussed below.

Substantially Contemporaneous Exchange

Hedrick held that the expiration of the relation back period (then 10 days) does not necessarily mean that a borrower's grant of a mortgage was not "substantially contemporaneous" with the receipt of the loan funds. In other words, the relation back period is a safe harbor, not a deadline. Check your local federal Court of Appeals for the rule that applies in your Circuit. *Compare Collins* with *Hedrick* (collecting cases). In a Circuit that follows *Hedrick,* it might be possible to persuade a bankruptcy court that a mortgage recorded more than 30 days after the loan closing was a substantially contemporaneous exchange.

Equitable Subrogation

There is a split of authority on whether the equitable subrogation doctrine provides a viable defense to a suit to avoid a preference:

- *In re Hedrick*, supra (subrogation rights under Georgia law arose when loan closed, more than 90 days before the debtor's bankruptcy petition);
- *Superior Bank, FSB v. Boyd (In re Lewis)*, 398 F.3d 735 (6th Cir. 2005) (subrogation denied on state law grounds).

Inquiry Notice

The court in *Hedrick* rejected a trustee's preference action based on theories of equitable subrogation and inquiry notice. NovaStar Mortgage made a refinancing loan to the Hedricks, but the security deed was not recorded within the relation back period, and the Hedricks filed a bankruptcy petition within 90 days of the recordation date. The releases of prior mortgages were not recorded until after the recordation of NovaStar's security deed. Interpreting Georgia law, the 11th Circuit held that Novastar's mortgage was perfected outside the preference period because NovaStar acquired a viable equitable subrogation claim more than 90 days before the Hedricks' bankruptcy petition. This claim was perfected against a good faith purchaser because the unreleased prior mortgage would put a purchaser on notice of possible prior liens.

Bankruptcy Statute Of Limitations

This is covered in a separate section below.

Defenses To Recovery

This is covered in a separate section below.

Suits To Avoid Fraudulent Transfers

The Bankruptcy Code permits the trustee to avoid fraudulent transfers voluntarily or involuntarily made within two years before the debtor's bankruptcy petition. 11 U.S.C. §548. The Bankruptcy Code declares a transfer fraudulent if it is made:

- With intent to "hinder, delay or defraud creditors"; or
- For less than "reasonably equivalent value" if: (i) the debtor was insolvent at the time of the transfer; (ii) the transfer rendered the debtor insolvent; (iii) the transfer left the debtor with unreasonably small capital for conducting its business; (iv) the debtor intended to incur debts he could not pay; or (v) the transfer was to benefit an insider.

The cases below illustrate transfers declared fraudulent under the Bankruptcy Code:

- Before filing bankruptcy, a homeowner deeded a house for no consideration to himself and his wife. *In re Greenfield*, 249 B.R. 856, 858 (Bankr. D. Mich. 2000);
- A corporation granted a mortgage to a bank to finance a leveraged buyout, leaving the corporation insufficiently capitalized. *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987);
- Subsidiary corporations borrowed money to pay their parent corporation's debt, leaving themselves with unreasonably small capital and unable to pay their debts as they matured. *In re TOUSA, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009).

Tabor Court prompted the American Title Insurance Association (ALTA) to amend its standard policy forms to add a creditors rights' exclusion. *TOUSA* prompted ALTA to decertify endorsement form 21, which insured against creditors' rights claims.

Defenses To Suits To Avoid Fraudulent Transfers

The following defenses are available against suits to avoid fraudulent transfers.

Good Faith Purchaser

A good faith purchaser from the debtor is protected to the extent of value given for the transfer. 11 U.S.C. §548 (c). This defense is inapplicable

to a transfer avoided under 11 U.S.C. §§544, 545 (avoidance of statutory liens) or 547 (preferences). 11 U.S.C. §548 (c).

Bankruptcy Statute Of Limitations

This is covered in the next section;

Defenses To Recovery

This is covered in a separate section below.

Bankruptcy Statute Of Limitations For Avoiding Pre-Petition Transfers

The trustee must bring an action to avoid a transfer under 11 U.S.C. §544, 547 or 548 by the earlier of:

- The later of: two years after petition (voluntary case) or order for relief (involuntary case); or one year after the appointment of the first trustee, if appointment occurs before expiration of the two-year period; or
- The time the case is closed or dismissed.

11 U.S.C. §546 (a).

Suits To Avoid Unauthorized Post-Petition Transfers

Generally, the trustee may avoid any unauthorized post-petition transfer of property of the estate. 11 U.S.C. §549 (a).

Defenses To Suits To avoid Unauthorized Post-Petition Transfers

Discussed below are defenses to suits to avoid post-petition transfers.

Gap Transfer In Involuntary Bankruptcy

A person who acquires property from the debtor during the "gap" between an involuntary bankruptcy petition and order for relief is protected to the extent of the value given for the transfer. 11 U.S.C. §549 (b). BAPCPA amended 11 U.S.C. §549 (b) to protect mortgage lenders, in effect overruling *In re McConville*, 110 F.3d 47 (9th Cir. 1997), *cert. denied*, 522 U.S. 966 (1997).

Good Faith Purchaser

A good faith purchaser who paid present fair equivalent value for the property may keep the property. 11 U.S.C. §549 (c). If the good faith purchaser did not pay present fair equivalent value, the trustee may avoid the transfer, but the purchaser retains a lien to the extent of any present value given. 11 U.S.C. §549 (c).

Section 549 Statute Of Limitations

The trustee must sue to avoid the transfer by the earlier of two years after the date of the transfer, or the time the case is closed or dismissed. 11 U.S.C. §549 (d).

No Harm, No Foul

McCord v. Agard (In re Ainsley H. Bean), 252 F.3d 113, 117 (2d Cir. 2001) (debtor sold property for market value post-petition and turned the sales proceeds over to the trustee).

Defense To "Recovery" By Transferee Of Possessory Interest

If the trustee avoids a transfer of a possessory interest in real estate under 11 U.S.C. §544, 547, 548, 549 or certain other sections, the avoidance of the transfer does not bring the property into the estate. The trustee needs to take another step to recover the property or its value.

A debtor's right to possess property under a deed or lease would constitute a possessory interest. Recovery is unnecessary if the avoided transfer involved a non-possessory interest, such as a lender's rights under mortgage. *Suhar v. Burns (In re Burns)*, 322 F.3d 421 (6th Cir. 2003).

Section 550 provides that the trustee may recover the property transferred, or, if the court so orders, the value of such property, from the initial transferee or any immediate or mediate transferee

of such initial transferee. 11 U.S.C. §550 (a). However, the Bankruptcy Code provides defenses to transferees who are good faith purchasers:

- If the trustee recovers property from the initial transferee, an initial transferee who is a good faith purchaser receives a lien on the property to secure the lesser of: (i) the cost, to such transferee, of any improvement made after the transfer, less the amount of any profit realized by or accruing to such transferee from such property; and (ii) any increase in the value of such property as a result of the improvement. 11 U.S.C. §550 (e)(1);
- The trustee may not recover the property from any immediate or mediate transferee of the initial transferee if the immediate or mediate transferee is a good faith purchaser. 11 U.S.C. §550 (b).

CONCLUSION • Some title problems are easier to fix than others, but it is never easy when there is an overlay of bankruptcy. The Bankruptcy Code gives the trustee the powers of a good faith purchaser, one of the most favored litigants known to the law, and the power to avoid preferences, fraudulent transfers, unauthorized post-petition transfers, and certain other transfers. You need to know the potential defenses to the trustee's formidable powers of avoidance and recovery. Above all, you need to know that the trustee will put up a fight, but it's a fight you may be able to win.

PRACTICE CHECKLIST FOR
How To Defend Avoidance Actions In Bankruptcy Litigation

- Anticipate how a bankruptcy trustee can avoid a deed or mortgage granted by a debtor even before a bankruptcy petition. The trustee can:

__ Exercise the rights of a good faith purchaser under 11 U.S.C. §544, sometimes called the "strong arm" clause;
__ Avoid preferences under 11 U.S.C. §547;
__ Avoid fraudulent transfers under 11 U.S.C. §548;
__ Cancel certain post-petition actions affecting the property of the estate;
__ Avoid any unauthorized post-petition transfer of the debtor's property. 11 U.S.C. §549;
__ Argue for setting aside a post-petition foreclosure sale that violated the Bankruptcy Code's automatic stay of lien enforcement actions against property of the debtor's estate.

- Defenses to strong arm suits include:

__ Curative statutes;
__ Equitable subrogation;
__ Trustee's constructive notice;
__ Constructive trust;
__ Debtor-in-possession's or trustee's actual knowledge of the mortgage;
__ Bankruptcy statute of limitations;
__ Making a deal with the trustee.

- Defenses to suits to avoid preferences include:

__ Substantially contemporaneous exchange;
__ Equitable subrogation;
__ Inquiry notice;
__ Bankruptcy statute of limitations;
__ Defenses to recovery.

- Defenses to suits to avoid fraudulent transfers include:

__ Good faith purchaser;
__ Bankruptcy statute of limitations;
__ Defenses to recovery.

- Defenses to suits to avoid unauthorized post-petition transfers include:

__ Gap transfer in involuntary bankruptcy;
__ Good faith purchaser;
__ Section 549 statute of limitations