HOW BANKRUPTCY AFFECTS REAL ESTATE TITLES AND BANKRUPTCY RISKS COVERED BY TITLE INSURANCE

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I. A Bankruptcy Petition Creates an Estate.

The filing of a bankruptcy petition creates an "estate" that includes all of the debtor's legal and equitable interests in property at the date of the petition, as well as property that the debtor inherits or obtains by separation or divorce within 180 days after the date of the petition. 11 U.S.C. §541. Title to the property remains property of the estate unless: (1) exempted by an individual debtor pursuant to 11 U.S.C. §522; (2) sold in accordance with the requirements of the Bankruptcy Code; (3) the bankruptcy court enters an order dismissing the bankruptcy; (4) the property is abandoned by court order or by action of the trustee; (5) the bankruptcy court allows a secured creditor to foreclose a lien on the debtor's property; or (6) title to the property re-vests in the debtor pursuant to a confirmed plan of reorganization.

II. Property Outside the Estate.

A. Property that the debtor holds in trust. Property in which the debtor holds, as of the commencement of a case, only legal title and not an equitable interest, becomes property of the estate only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold. 11 U.S.C. 541(d). See In re Unicorn Computer Corp., 13 F.3d 321 (9th Cir. 1994); In re Dameron, 155 F.3d 718 (4th Cir. 1998).

B. Property of a Partnership in which the Debtor is a Partner. The Bankruptcy Code regards a partnership as an entity separate from its partners. Therefore, a partnership's property is not part of a partner's estate in bankruptcy. Conversely, a partner's property is not part of a partnership's estate in bankruptcy.

III. Exempt property.

A. Exemptions are available only to individuals. 11 U.S.C. §522 (b).

B. Property exempted ceases to be property of the estate. 11 U.S.C. §522 (b).

C. Debtor may choose between federal and state exemptions, unless state has opted out. For an example of an opt-out statute, see Colo. Rev. Stat. §13-54-107 (2000).

1. The federal homestead exemption is $16,150.00. 11 U.S.C. §522 (d) (1).

2. State exemptions:

a.) State homestead exemption. E.g., Colo. Rev. Stat. §13-41-201 (2000) (allowing debtor to exempt $45,000 of home equity); Virginia Codes §34-4 ($5000.00, applicable to any kind of property).

b.) Joint tenancy or tenancy by the entirety property, to the extent exempt from process under applicable state law. 11 U.S.C. '522 (b)(2)(B). See, Sumy v. Schlossberg, 777 F.2d 921 (4th Cir. 1985) (debtor's interest in tenancy by the entirety property cannot be sold to satisfy a debt that is not the joint obligation of both spouses; however, tenancy by entirety property is subject to administration as part of the bankrupt estate for the benefit of joint creditors, even if one spouse is not a debtor). This exception is inapplicable in Colorado, which does not recognize the estate of tenancy by the entirety. Whyman v. Johnson, 163 P. 76, 78 (Colo. 1917).

IV. Title to Property of the Estate.

A. Trustee. In a voluntary liquidation bankruptcy (Chapter 7), title to the property of the estate passes to an "interim trustee" appointed by the bankruptcy court. At the first meeting of creditors, the creditors may elect a new trustee, who will replace the interim trustee. The trustee, rather than the debtor, holds legal title to the property of the estate. However, in an involuntary Chapter 7, title to the debtor's property does not pass to a trustee unless and until the bankruptcy court enters an order for relief or, without entering an order for relief, appoints a trustee to preserve the estate's property or prevent loss to the estate. 11 U.S.C. §303 (f) and (g).

B. Debtor in Possession. In a Chapter 11 reorganization proceeding, the debtor generally retains title to property of the estate, but holds the property in trust, and has the powers and duties of a trustee in bankruptcy. 11 U.S.C. §1107. The bankruptcy court, for cause, may appoint a trustee to administer the estate; in that event, title to estate property vests in the trustee.

C. Effect of Conversion. Conversion of a case (e.g., from Chapter 11 to Chapter 7) transfers control of the estate to a new trustee, who will need to seek re-approval of a pending sale or mortgage transaction that has not been consummated prior to the conversion date. 11 U.S.C. §348; 11 U.S.C. §365 (d) (1).

V. Trustee's Title is Unperfected Until Notice of Bankruptcy Filed in Land Records.

The pendency of a bankruptcy case does not constitute constructive notice that title to the debtor's property has vested in the trustee. 11 U.S.C. §549 (c). However, a bankruptcy trustee can perfect his title against persons claiming under the debtor by filing a notice of bankruptcy in the public land records. Id.

A. Generally, a Trustee May Avoid Unauthorized Post-Petition Transfers. 11 U.S.C. §549 (a).

B. Involuntary Case Exception. In an involuntary case, the debtor is free to transfer his property until an order for relief is entered. 11 U.S.C. §549 (b). The transferee's title is protected to the extent of value given, except release of a pre-petition debt. Id.

C. Protection of Good Faith Purchasers. If the trustee has not recorded a notice of bankruptcy, the Bankruptcy Code provides limited protection to a good faith purchaser from the debtor.

1. The trustee cannot set aside the title of a good faith purchaser who buys real estate from the debtor for "present fair equivalent value," unless the purchaser had actual or constructive knowledge of the bankruptcy. 11 U.S.C. §549 (c).

2. If a good faith purchaser without actual or constructive knowledge of the bankruptcy case buys property from the debtor for less than "present fair equivalent value," the trustee may set aside the purchaser's deed. In that event, the purchaser will be entitled to a lien to the extent of any present value given to the debtor. Id.

D. Are Mortgage Lenders Protected as Good Faith Purchasers? One federal court of appeals held that the protection afforded by 11 U.S.C. §549 (c) applies only to purchasers, not mortgage lenders. In re McConville (Thompson v. Margen), 110 F.3d 47 (9th Cir. 1997) (superseding Thompson v. Margen, 97 F.3d 316 (9th Cir. 1996)). The decision is debatable, and the pending Bankruptcy Reform Bill would reverse it.

VI. Selling, Leasing or Mortgaging Property of the Estate.

In an involuntary case, the debtor can continue to "use, acquire, or dispose of property as if an involuntary case had not been commenced" until an order for relief is entered or the bankruptcy court orders otherwise. 11 U.S.C. §303 (f).

A trustee or debtor in possession usually needs to obtain an order from the bankruptcy court authorizing the sale, leasing or mortgaging of property of the estate. Such orders are not legally required for selling and leasing property in the ordinary course of the debtor's business - e.g., a homebuilder in a Chapter 11 case should be able to continue to sell homes in the ordinary course of business without specific bankruptcy court authorization. 11 U.S.C. §363 (c). However, title insurance companies are reluctant to insure a real estate transaction by a trustee or debtor in possession unless the bankruptcy court has entered an order authorizing the transaction. Usually title insurers require proof that proper notice of the proposed transaction was given to parties in interest. Title insurers' requirements vary depending on the kind of bankruptcy:

A. Chapter 7 (liquidation)

1. Court order authorizing sale of the property by the debtor's trustee in bankruptcy (deed will come from Trustee); or

2. Proof that the property has been abandoned by the debtor's trustee in bankruptcy (deed will come from the debtor). See discussion below regarding abandonment.

B. Chapter 11 (reorganization)

1. Court order authorizing the proposed sale or encumbrance of the property; or

2. Copy of confirmed plan of reorganization that provides for the proposed sale or encumbrance of the property.

Normally, the deed will be signed by the debtor in possession, as "debtor in possession." However, if the bankruptcy court has appointed a trustee for the debtor's estate, the trustee will need to sign the deed.

C. Chapter 12 (adjustment of family farmer debts)

1. Court order approving proposed sale or encumbrance; or

2. Confirmed plan under which title to the property re-vests in the debtor.

D. Chapter 13 (wage earner plans)

1. Court order approving proposed sale or encumbrance; or

2. Confirmed wage earner's plan under which title to the property re-vests in the debtor.

VII. Effect of Appeal of Order Authorizing Sale.

A. Reversal on appeal does not affect the title acquired by good faith purchaser, even if the purchaser knew about the appeal, unless the order was stayed pending appeal. 11 U.S.C. §363 (m).

B. The usual 10-day stay of the effectiveness of bankruptcy court orders is inapplicable to orders approving the sale or lease of property of the estate. Fed. R. Bankr. P. 8017.

VIII. Abandonment of Property of the Estate.

After notice and hearing, a Chapter 7 trustee may abandon property without a court order. 11 U.S.C. §554 (a); In re Terjen, 154 B.R. 456 (Bankr. E.D.Va.), aff'd 30 F.3d 131 (4th Cir. 1994). The usual ground for abandonment is that the property is of no value to the estate. No actual hearing is required as long as the trustee gives proper notice, provided no party in interest makes a timely request for a hearing. Also, the bankruptcy court may order the trustee to abandon property upon the motion of a party in interest. 11 U.S.C. §554 (b). Once the property is abandoned, title reverts to the debtor. In re Terjen, supra; In re Johnston, 49 F.3d 538 (9th Cir. 1995).

When the debtor later sells or mortgages the property, the title insurance company for the purchaser or lender will require proof that the property was abandoned upon proper notice. Many title insurance underwriters will ask a Chapter 7 trustee for written confirmation of the abandonment as a condition to insuring title in a subsequent transfer or financing of the property.

IX. Foreclosure Sales.

A bankruptcy petition automatically stays any legal proceeding against the debtor, the debtors property or property of the estate. 11 U.S.C. §362. Therefore, no foreclosure sale of property of the estate may proceed unless the automatic stay has been terminated.

A. Duration of the Automatic Stay.

1. The automatic stay takes effect immediately and automatically when a bankruptcy petition is filed by or against the debtor.

2. The automatic stay ends as to real estate on the earliest of the date on which:

a.) the bankruptcy case is closed; or

b.) the bankruptcy case is dismissed; or

c.) an individual is granted or denied a discharge (if the real estate is no longer property of the estate); or

d.) the bankruptcy court grants a creditor relief from the automatic stay (and, per Bankruptcy Rule 4001(a)(3), ten days elapse from the date of the order, unless the bankruptcy court specifically orders that the stay be dissolved immediately).

B. Consequences of Violating the Automatic Stay:

1. The bankruptcy court may punish the violator for contempt of court; and

2. An individual injured by a willful violation of a stay may recover actual damages, including costs and attorneys fees, and, in appropriate circumstances, punitive damages. 11 U.S.C. §362 (h); and

3. Most courts hold that a foreclosure sale in violation of the stay is void. See Kalb v. Feuerstein, 308 U.S. 433 (1940); In re Soares, 107 F.3d 969 (1st Cir. 1997).

X. Effect of Bankruptcy on Pre-Petition Liens and Interests.

Judgments and financing liens that have attached to property prior to a debtor's bankruptcy petition are unaffected by the bankruptcy, unless the bankruptcy court enters a valid order affecting those interests. Johnson v. Home State Bank, 501 U.S. 78, 82-83 (1991) (discharge of mortgage debt did not prevent lender from foreclosing a mortgage granted by the debtor prior to his bankruptcy); Cen-Pen Corp. v. Hanson, 58 F.3d 89 (4th Cir. 1995) ("A bankruptcy discharge extinguishes only in personam claims against the debtor(s), but generally has no effect on an in rem claim against the debtor's property.") However, some kinds of executory contracts and various rights under leases will be affected if the debtor fails to affirm the contract or lease.

A. Judgments and liens. A judgment or other lien that has attached to a debtor's real estate prior to his bankruptcy survives the bankruptcy unless the bankruptcy court issues a valid order that sets the lien aside. However, the bankruptcy court may release property from liens or modify liens in the following circumstances:

1. The bankruptcy court may authorize a sale of property free and clear of liens or other interests under 11 U.S.C. §363 (f) if: (i) applicable nonbankruptcy law permits the sale of such property free and clear of such interest; (ii) the lienholder or other party in interest consents; (iii) such interest is a lien, and the price at which the property is to be sold is greater than the aggregate value of all liens on the property; (iv) such interest is in bona fide dispute; or (v) the owner of the interest could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of the interest. Whenever property is sold free and clear of a lien under §363, the lien attaches to the proceeds of the sale.

2. Some liens may be voided under one of the trustee=s avoidance powers:

a.) The Bankruptcy Code's "strong arm" clause, 11 U.S.C. §544, gives the trustee or debtor in possession the power to avoid any transfer that would be voidable by a creditor under state law. Examples:

i.) a transfer void as to a good faith purchaser under the applicable recording statute. See Mayer v. United States (In re Reasonover), 236 B.R. 219 (E.D. Va. 1999) (applying Virginia code §55-96) , remanded sub nom. Countrywide Home Loans v. United States, No. 99-2534, No. 99-2620, 2000 U.S. App. LEXIS 33672 (4th Cir. Dec. 22, 2000).

ii.) a transfer voidable under state law authorizing creditors to set aside fraudulent or voluntary transfers (e.g., Virginia Code §§55-80 and -81).

b.) Preferential transfers voidable under 11 U.S.C. §547.[1]

c.) Fraudulent transfers voidable under 11 U.S.C. §548.[2]

d.) Unauthorized post-petition transfers voidable under 11 U.S.C. §549. Note that 11 U.S.C. §550 protects a subsequent transferee who takes for value, in good faith, and without knowledge of the voidability of a transfer avoided under §§544, 548, 549 and certain other sections of the Bankruptcy Code.

3. In some kinds of cases the court may approve a reorganization or payment plan that reduces the lien of a mortgage to the value of the lender's interest in the security property:

a.) In a Chapter 11 reorganization, the bankruptcy court may approve a plan of reorganization that alters the rights of a mortgage lender, provides for the sale of property free and clear of liens or interests, or provides for the debtor to retain title to the property. In such reorganizations, a secured creditor's rights cannot be impaired unless: (i) the secured creditor consents; or (ii) the plan does not discriminate unfairly and is "fair and equitable." 11 U.S.C. §1129 (b)(1). To be fair and equitable to a mortgage lender, a Chapter 11 plan must provide: (i) for the mortgage lender to retain its lien to the extent of the allowed amount of the lender's secured claim and receive payments having a value, at the effective date of the plan, of at least the value of the mortgagee's interest in the estate's interest in the property; (ii) that the property be sold free and clear of liens, with such liens to attach to the proceeds of sale; or (iii) that the mortgage lender will receive the "indubitable equivalent" of its allowed secured claim. 11 U.S.C. §1129 (b)(2).

b.) A Chapter 12 plan may "strip down" a mortgage to the value of the land encumbered. 11 U.S.C. §1225 (a)(5)(b); 1 Robert E. Ginsberg & Robert D. Martin, Ginsberg & Martin on Bankruptcy §14.04 [I] (4th Ed. 1998).

c.) Chapter 13 wage earner plans may strip down a mortgage (except a mortgage secured only by the debtor's primary residence) in the same manner as a plan under Chapter 11 or Chapter 12. However, a Chapter 13 plan may not impair the rights of the a mortgage lender secured only by a lien on the debtor's primary residence except:

i.) such mortgages may be modified with secured creditor's consent;

ii.) a Chapter 13 plan may provide for defaults under such mortgages to be cured within a reasonable time, if the mortgage has not been foreclosed;

iii.) if the last payment on the original payment schedule for the mortgage is due prior to the final payment to be made under the Chapter 13 plan, the mortgage may be modified in generally the same manner as allowed for plans under Chapter 11 and Chapter 12. 11 U.S.C. §§1322 (b)(2) and

1325 (a)(5). Chapter 13 plans provide for payments to be made over a period not to exceed three years, which the court may extend for cause to five years.

Some courts hold that in a Chapter 13 case, the bankruptcy court may "strip off" a junior lien on the debtor's personal residence B i.e., remove the lien from the debtor's property, if the junior lien is wholly unsecured. In re Bartee, 212 F.3d 277 (5th Cir. 2000); In re Yi, 219 B.R. 394 (E.D.Va. 1998).

However, in a Chapter 7 liquidation case, an undersecured mortgage may not be "stripped down" to the value of the security available for the undersecured lender. Dewsnup v. Timm, 502 U.S. 410 (1992) (bankruptcy court erred in dividing the claim of an undersecured mortgage lender into two separate claims: (i) a secured claim equal to the value of the security property; plus (ii) an unsecured claim for the balance). In light of Dewsnup, it is questionable that a wholly undersecured mortgage could be stripped off in a Chapter 7 liquidation.

B. Interests of co-tenants.

1. The bankruptcy court may authorize the trustee to sell property of an individual debtor free and clear of any vested or contingent right in the nature of dower or courtesy. 11 U.S.C. §363 (g). However, the debtor's spouse will have a right of first refusal in connection with any such sale. 11 U.S.C. §363 (i).

2. The bankruptcy court may authorize the sale of the debtor's property free and clear of the interests of a co-tenant if: (i) partition is impracticable, (ii) a sale of the entire interest in the property would realize more for the estate than the sale of only the debtor's interest, and (iii) the benefit to the estate would outweigh the detriment to the co-owner. However,

a.) the bankruptcy court may not order a partition sale of property used by certain utility companies for the production or distribution of electric energy or natural or synthetic gas for heat, light or power. 11 U.S.C. §363 (h); and

b.) the co-owner has a right of first refusal in connection with any such proposed sale. 11 U.S.C. §363 (i).

3. Where property is held by a husband and wife as tenants by the entirety, but only one is a debtor in bankruptcy, the bankruptcy court may order the property sold to satisfy joint debts of the husband and wife. Sumy v. Schlossberg, 777 F.2d 921 (4th Cir. 1985). However, the debtors equity in the property, after the satisfaction of all joint debts, may be exempted, if tenancy by the entirety property is exempt under state law from execution to satisfy the debt of only one of the spouses.

C. Executory Contracts and Unexpired Leases. Section 365 of the Bankruptcy Code gives the trustee the right to affirm or reject executory contracts and unexpired leases. This section has two purposes: (i) if a lease or contract has value for the estate, the trustee or debtor-in-possession can preserve the lease or contract for the benefit of the estate; and (ii) if a lease or contract is burdensome to the estate, the trustee or debtor in possession may reject the lease or contact. To preserve the trustee's right to affirm a lease or contract, the Bankruptcy Code invalidates "ipso facto" clauses that declare a lease or contract terminated in the event of the debtor's bankruptcy. 11 U.S.C. §365 (b)(2)(B). The trustee's rejection of a lease or contract constitutes a breach. The other party's remedy for the breach depends on various circumstances addressed by the Bankruptcy Code.

1. Generally, a contract to purchase real estate is subject to rejection by the trustee, and the other party's remedy is to file a proof of claim. If the debtor rejects a contract to sell property, the purchaser cannot compel specific

performance of the contract, unless the purchaser is in possession of the property under an installment sales contract. 11 U.S.C. §365 (i).

2. Most courts hold that options to purchase real estate may be rejected to the same extent as contracts. See, e.g., In re A.J. Lane & Company, 107 B.R. 435, 439 (Bankr. D. Mass. 1989).

3. Rejections of leases raise complicated issues, but cannot terminate a leasehold estate over the objection of a tenant or, if the lease has been properly drafted, a leasehold mortgagee:

a.) If the debtor is the tenant, the debtor may reject the lease, whereupon the landlord will have a claim against the estate for past and future rent. Future rent claims are limited to the lesser of: (i) all future rent payable under the lease; or (ii) two years' rent.

b.) A tenant's rejection of a lease does not destroy the interest of a leasehold mortgagee, but merely places the lease outside the jurisdiction of the Bankruptcy Court. If a ground lease or separate agreement gives the leasehold mortgagee a right to cure the tenant's defaults, the leasehold mortgagee may exercise those rights and preserve the lease, notwithstanding the tenant's bankruptcy and rejection of the lease. Matter of Garfinkle, 577 F.2d 902 (5th Cir. 1978); In re Austin Dev. Co., 19 F.3d 1077 (5th Cir. 1994); In re 1438 Meridian Place, N.W., 11 B.R. 352 (Bankr. D.D.C. 1981).

c.) If the debtor is the landlord, the debtor's rejection of the lease does not necessarily deprive the tenant of his estate in the property, provided that the lease term has commenced. Instead, the tenant is given the option of: (i) terminating the lease, if the rejection constitutes a material breach that would give the tenant the right to terminate under state law; or (ii) keeping the leasehold estate in effect, and offsetting against rent any damages resulting from the landlord's rejection of its obligations. 11 U.S.C. §365 (h).

XI. Effect of Discharge.

A. No Effect on Pre-Petition Judgment Liens. A discharge granted to an individual does not affect a judgment lien that attached to a debtor's property prior to his bankruptcy petition. Leasing Serv. Corp. v. Justice, 243 Va. 441 (1992). The same rule applies to other kinds of pre-petition liens.

B. Discharged Judgments Do Not Affect Property Acquired After Discharge. Judgments discharged in bankruptcy are ineffective to create a lien on property acquired by the debtor after the date of the discharge.

XII. Bankruptcy Risks Covered by Title Insurance.

In the 1980s title insurance companies were forced to defend and sometimes pay claims arising out of suits to set aside real estate conveyances as fraudulent or preferential transfers under the Bankruptcy Code. See, e.g., United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), cert. denied, McClennan Realty Co. v. United States, 483 U.S. 1005, 107 S.Ct. 3229 (1987) (leveraged buyout was alleged to be fraudulent transfer under 11 U.S.C. §548). Title insurance companies responded to this perceived risk by adding so-called creditors' rights exceptions to their title insurance policies.

The practice became so widespread that, in 1990, the American Land Title Association ("ALTA") revised its standard form of title insurance policy by adding a broad exclusion covering any title defect arising under creditors' rights laws. The creditors' rights exclusion promulgated by ALTA in 1990 for use in loan policies excluded coverage of "[a]ny claim,

which arises out of the transaction creating the interest of the mortgagee insured by this policy, by reason of the operation of federal bankruptcy, state insolvency or similar creditors' rights laws."

ALTA revised the form further in 1992 to provide that the title insurance company would be responsible for losses under creditors' rights laws that arose from title search errors or improper conveyancing practices - e.g., a defective deed, break in the chain of title, or failure to record a document. However, the insured owner or lender still bears the risk that the transaction insured may be set aside as preference or fraudulent transfer because of the financial structure of the transaction. The creditors' rights exclusion in the 1992 ALTA loan policy excludes coverage of claims resulting from:

> Any claim, which arises out of the transaction creating the interest of the mortgagee insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that is based on:
>
> **a.)** the transaction creating the interest of the insured mortgagee being deemed a fraudulent conveyance or fraudulent transfer; or
>
> **b.)** the subordination of the interest of the insured mortgagee as a result of the application of the doctrine of equitable subordination; or
>
> **c.)** the transaction creating the interest of the insured mortgagee being deemed a preferential transfer except where the preferential transfer results from the failure:
>
> **i.)** to timely record the instrument of transfer; or
>
> **ii.)** of such recordation to impart notice to a purchaser for value or a judgment or lien creditor.

A. The exclusion is inapplicable to prior transactions. The exclusion applies to claims arising out of the transaction creating the interest insured by the policy. Creditors' rights claims arising out of prior transactions fall outside the exclusion. Therefore, the policy insures against the risk that prior transactions in the chain of title could be set aside under creditors' rights laws.

B. The exclusion is inapplicable to claims arising from lack of perfection. If the title company fails to record a deed, or if the deed is ineffective to impart constructive notice to a good faith purchaser, the company is responsible for any loss resulting from a bankruptcy trustee's exercise of his "strong arm" powers under §544.

C. The exclusion covers only three kinds of claims:

1. **Fraudulent transfers.** A purchaser, rather than the title insurance company, takes the risk that the transaction may be avoided under §548 of the Bankruptcy Code because the purchaser failed to pay "reasonably equivalent value" for property that the debtor conveyed while insolvent.

2. **Equitable subordination of insured deed of trust.** Under this exclusion, the lender remains responsible for title risks arising out of the lender's own inequitable conduct.

3. **Preferential transfers.** Generally, the transferee bears the risk that a transfer may be set aside as a preference under §547 of the Bankruptcy Code. However, the title insurer is responsible for damages in the case of preferences resulting from: (i) delay in recordation of the insured deed or mortgage; or (ii) failure of the insured deed or mortgage to impart constructive notice to third parties.

D. Examples of Creditors' Rights Claims Potentially Covered by Title Insurance.

1. **Break in chain of title.** In Mayer v. United States (In re Reasonover), 236 B.R. 219 (E.D. Va. 1999), the debtor, Ms. Reasonover, acquired a house for renovation and resale. After she fixed up the property, she thought she conveyed title to a corporation she owned. However, she never signed a deed to the corporation. The corporation then signed a deed purporting to transfer title to a purchaser, who granted a purchase money deed of trust to Countrywide. Because Ms. Reasonover never deeded the property to the corporation, there was a break in Countrywide's chain of title, which became an even greater problem for Countrywide when Ms. Reasonover filed a petition under Chapter 7 of the Bankruptcy Code.

   The Bankruptcy Court ruled, under Section 544 of the Bankruptcy Code, that the Trustee stood in the shoes of a hypothetical bona fide purchaser without notice of Mrs. Reasonover's intention to convey the property to her corporation. Therefore, the Trustee's rights in the property trumped Countrywide's, except as one of two subrogation claims asserted by Countrywide.

   Countrywide asserted that it was entitled to be subrogated to the rights of two prior mortgage lenders who had been paid off with the proceeds of Countrywide's loan. One of the prior mortgages had been released of record prior to Ms. Reasonover's Chapter 7 petition; the other had not. The Bankruptcy Court ruled that the Trustee was not a bona fide purchaser as to the unreleased mortgage because the trustee was on constructive notice of that lien. Therefore, Countrywide could stand in the shoes of the former lender under the doctrine of equitable subrogation. However, the Trustee was a bona fide purchaser as to the mortgage that had been released of record. Therefore, Countrywide would not be subrogated to the rights of the former mortgagee whose lien remained unreleased.

   Reasonover still has not been finally decided. The United States District Court affirmed the Bankruptcy Court's decision, but the United States Court of Appeals for the Fourth Circuit remanded the case for consideration of whether 11 U.S.C. §550 provided Countrywide with a defense against the Trustee's claim. Section 550 of the Bankruptcy Code protects a transferee who takes for value without knowledge of the voidability of the transfer avoided. However, Section 550 may be inapplicable because there was never any transfer from Ms. Reasonover to her corporation. Tune in next year for the exciting answer to this bankruptcy conundrum.

   The outcome under the title policy is more certain. Under the 1992 ALTA policy, the title insurance company would be responsible for any loss sustained by Countrywide because: (i) the creditors' rights claim that gave rise to the loss did not arise from a fraudulent transfer, equitable subordination or a preference; and (ii) the break in the chain of title occurred prior to the transaction in which Countrywide acquired an interest in the policy.

2. **Defective mortgage.** In re Jones, 226 F.3d 917 (7th Cir. 2000), held that a bankruptcy trustee could recover a payment received by a lender within the preference period pursuant to a foreclosure sale under a defective mortgage. The mortgage in question had not been witnessed as required under Ohio law. Because the mortgage was not a valid lien, the foreclosure sale proceeds constituted a pre-petition payment to an unsecured creditor. The payment was voidable as a preference because lender received a greater distribution than the lender would have received in a pro-rata distribution to unsecured creditors under Chapter 7.

   If the lender had a title insurance policy, the title insurer may be liable because the lender's loss arose out of the failure of the mortgage to impart constructive notice. However, the title insurer might have a policy defense

because the mortgage was not "witnessed" until after the borrowers signed it and mailed it to the lender. Could it be that the title defect was created, suffered, assumed or agreed to by the insured claimant?

[1] Subject to certain exceptions, Section 547 allows the Trustee to avoid a transfer of the debtor's property:
(1) to or for the benefit of a creditor;
(2) to pay an antecedent debt;
(3) made while the debtor was insolvent;
(4) made on or within 90 days before the date of the petition (or on or within one year if the transfer was to an "insider"); and
(5) that enables the creditor to obtain more than creditor's share of a Chapter 7 liquidation of the debtor's estate.

However, the trustee may not avoid: a transfer intended as a "contemporaneous exchange for new value given to the debtor," if the exchange was, in fact, substantially contemporaneous; a payment of a debt incurred in the ordinary course of business if the payment was made in the ordinary course of business according to ordinary business terms; or a purchase money security interest that is perfected on or before 20 days after the debtor receives the property.

[2] A fraudulent transfer under the Bankruptcy Code is any pre-petition transfer of the debtor's property that:
(1) Occurred within the year prior to the filing of the petition;
(2) While the debtor was insolvent; and
(3) Was made for less than reasonably equivalent value