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# 20 Residential Real Estate in Bankruptcy

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This chapter is designed to provide accurate and authoritative information in regard to the subject matter discussed. In writing this chapter, however, the author is not engaged in rendering legal or professional service. The discussion in this chapter is not intended as legal advice applicable to any specific problem. The forms affixed to this chapter are not intended for direct use but must be adapted to the facts of any particular situation.

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## I. [20.1] INTRODUCTION

This chapter addresses issues confronted by the real estate practitioner whose buyer client is buying residential real estate subject to bankruptcy jurisdiction, whose lender client is attempting to foreclose on real estate subject to bankruptcy jurisdiction, or whose debtor client is attempting to reduce its mortgage debt to the value of the real estate. The buyer's counsel must get permission from the bankruptcy court to transfer title, the lender's counsel must remove the property from bankruptcy jurisdiction in order to continue with foreclosure efforts, and the debtor's counsel must obtain, if possible, bankruptcy court authority to strip off the lien of a mortgage lender, or simply modify its terms. The buyer, the lender, and the debtor must all acquire bankruptcy court approval.

The bankruptcy court is guided by the Bankruptcy Code, 11 U.S.C. §101, *et seq.*, which contains the substantive provisions of bankruptcy law. The Bankruptcy Code is divided into numbered chapters. The Federal Rules of Bankruptcy Procedure are used in conjunction with the Bankruptcy Code. The rules outline the procedures to be followed for the administration of bankruptcy cases.

Bankruptcy Code §109 explains who can be a debtor under which chapter of the Bankruptcy Code. Unless the debtor is a municipality, it uses Chapter 7, Chapter 11, Chapter 12, or Chapter 13. Chapter 7, 11 U.S.C. §701, *et seq.*, is the liquidating chapter of the Code. Chapter 11, 11 U.S.C. §1101, *et seq.*, is designated for the reorganization of either businesses or individuals. Chapter 12, 11 U.S.C. §1201, *et seq.*, provides relief for a "family farmer." See 11 U.S.C. §1203. Chapter 13, 11 U.S.C. §1301, *et seq.*, is the reorganization chapter for individuals with regular income. See 11 U.S.C. §109(e).

NOTE: The concept of fiduciary behavior is central to the administration of bankruptcy cases. The fiduciaries that are necessary parties to an effort to remove property from bankruptcy jurisdiction will vary depending on which chapter of the Code the debtor is using:

| Chapter | Parties |
|---|---|
| 7 | Trustee and Debtor |
| 11 | Debtor or Trustee |
| 12 | Trustee and Debtor |
| 13 | Trustee and Debtor |

If the debtor is using Chapter 7, a case trustee is assigned to act as the fiduciary for the benefit of the debtor's creditors. A debtor in Chapter 11 either operates its own business (hence is referred to as a "debtor-in-possession" (DIP)) or has its business operated by a trustee; in either case, the party operating the business acts as the fiduciary for the benefit of the creditors. The Chapter 12 debtor can either be in possession of its business operations or have its business operated by either a case trustee or a standing Chapter 12 trustee. A Chapter 13 debtor is subject to the fiduciary charge of a "standing" Chapter 13 trustee even though it remains in possession of its assets. Since the debtor in a case pending under the Bankruptcy Code has fiduciary responsibilities, the labels "debtor" and "trustee" are used interchangeably in this chapter.

The Department of Justice, United States Trustee's Office for the district in which the case is pending, supervises the trustee. The United States Trustee (UST) must also receive notice of any effort to sell property. If the UST requests notification, or if the court directs, counsel may be required to serve the UST with notice of other efforts to remove property from bankruptcy jurisdiction. Fed.R.Bankr.P. 2002(k) specifies the situations in which the UST must receive notice.

The sample forms in §§20.19 – 20.27 below are not intended for direct use but must be adapted to the facts of any particular situation.

## II. BANKRUPTCY JURISDICTION

### A. [20.2] Property of the Bankruptcy Estate

11 U.S.C. §541(a)(1) describes "property of the [bankruptcy] estate" as including all legal or equitable interests of a debtor in property as of the commencement of the case. In addition, certain sections of the Bankruptcy Code enable the trustee to avoid and administer transfers of property made by the debtor to third parties. See 11 U.S.C. §§363(n), 510(c), 543, 544, 548, 550, 551, 553, 723. Likewise, the estate includes certain acquisitions of the debtor received after the petition date. Accordingly, when a bankruptcy petition is filed, any interest of the debtor in real estate, whether it be a 100-percent fee interest, a joint tenancy interest, an interest as a tenant in common, a right of redemption, or a leasehold interest, is subject to bankruptcy jurisdiction.

In addition to certain post-petition acquisitions, any interest in real estate that the trustee acquires through his or her "avoiding powers" is subject to bankruptcy jurisdiction. The bankruptcy court has jurisdiction of this property of the estate, wherever it may be located. See 28 U.S.C. §1334. For a full description of all property of the estate, the reader is referred to 11 U.S.C. §541.

State law defines the debtor's "interest in property." Since the State of Illinois has opted out of the federal exemption statute at 11 U.S.C. §522, Illinois law also determines which property is exempt from inclusion in the bankruptcy estate of the Illinois resident. See 735 ILCS 5/12-1201, *et seq.* The Illinois homestead exemption was increased from $7,500 to $15,000 on January 6, 2006. As a result, equity available to bankruptcy estates for liquidation purposes is reduced. 735 ILCS 5/12-901.

NOTE: Since 1990, many married Illinois homeowners have elected to hold title to their homes as tenants by the entireties. If the debtor holds title to its residence as a tenant by the entirety, that interest is exempt from the claims against one of the tenants, pursuant to Illinois statute, "except if the property was transferred into tenancy by the entirety with the sole intent to avoid the payment of debts existing at the time of the transfer beyond the transferor's ability to pay those debts as they become due." 735 ILCS 5/12-112. Joint debt does, however, attach to entirety property. *Id.*

### B. [20.3] Bankruptcy Courts in Illinois

The United States Bankruptcy Court is a "unit" of the U.S. District Court. Accordingly, in Illinois, all of the bankruptcy cases are pending in either the U.S. Bankruptcy Court for the Central District of Illinois, the Southern District of Illinois, or the Northern District of Illinois.

The Bankruptcy Court for the Northern District of Illinois (www.ilnb.uscourts.gov) is divided into Eastern and Western Divisions. The Eastern Division covers Cook, DuPage, Grundy, Kane, Kendall, Lake, LaSalle, and Will Counties. The address is 219 S. Dearborn St., Chicago, IL 60604, phone 312-435-5694. The Western Division covers Boone, Carroll, DeKalb, JoDaviess, Lee, McHenry, Ogle, Stephenson, Whiteside, and Winnebago Counties. The address is 211 S. Court St., Rockford, IL 61101, phone 815-987-4350.

The Bankruptcy Court for the Central District of Illinois (www.ilcb.uscourts.gov) has three divisions — Peoria, Danville, and Springfield. The Peoria Division covers Bureau, Fulton, Hancock, Henderson, Henry, Knox, Marshall, McDonough, Mercer, Peoria, Putnam, Rock Island, Stark, Tazewell, Warren, and Woodford Counties. The address is 2nd Floor, Room 216, 100 N.E. Monroe St., Peoria, IL 61602, phone 309-671-7035. The Danville Division covers Champaign, Coles, Douglas, Edgar, Ford, Iroquois, Kankakee, Moultrie, Piatt, Vermillion, and Livingston Counties. The address is 1st Floor, Room 130, 201 N. Vermilion St., Danville, IL 61832, phone 217-431-4820. The Springfield Division covers Adams, Brown, Cass, DeWitt, Christian, Greene, Logan, Macon, Macoupin, Mason, McLean, Menard, Montgomery, Morgan, Pike, Sangamon, Scott, Schuyler, and Shelby Counties. The address is 2nd Floor, Room 226, 600 E. Monroe St., Springfield, IL 62701, phone 217-492-4551.

The Bankruptcy Court for the Southern District of Illinois (www.ilsb.uscourts.gov) has two divisions — Benton and East St. Louis. The Benton Division covers Alexander, Clark, Clay, Crawford, Cumberland, Edwards, Effingham, Fayette, Franklin, Gallatin, Hamilton, Hardin, Jackson, Jasper, Jefferson, Johnson, Lawrence, Marion, Massac, Perry, Pope, Pulaski, Randolph, Richland, Saline, Union, Wabash, Washington, Wayne, White, and Williamson Counties. The address is Federal Courthouse, 301 W. Main St., Benton, IL 62812, phone 618-435-2200. The East St. Louis Division covers Bond, Calhoun, Clinton, Jersey, Madison, Monroe, and St. Clair Counties. The address is Melvin Price Federal Courthouse, 750 Missouri Ave., East St. Louis, IL 62201, phone 618-482-9400.

The clerk of each bankruptcy court maintains a case docket for each bankruptcy case pending in the district. The websites for the courts also contain valuable case information, such as cases pending in the district. Reference to the court's website or to the clerk of the court directly allows the practitioner to determine if the person or entity in title to a particular piece of property is subject to bankruptcy jurisdiction. Each judge maintains his or her own website which contains important information about the judge's court calendar and standing orders. A review of the judge's website before filing any motions in bankruptcy court is recommended.

**PRACTICE POINTERS**

✓ To prosecute any available motion to cause the removal of property from bankruptcy jurisdiction or to negotiate a sales contract with the trustee, first contact the clerk of the bankruptcy court for the appropriate jurisdiction to determine

1. the chapter under which the case is pending;

2. the name, address, and phone number of the case trustee, if any;

3. the name, address, and phone number of the debtor's attorney;

4. the presiding judge and the days and times on which the presiding judge hears cases under each chapter;

5. the case number; and

6. the names and addresses of all creditors of the debtor.

The United States Trustee (www.justice.gov/ust/index.htm), who may be a party in interest, should then be contacted, if appropriate. The UST's District Office for the Northern District of Illinois, Eastern Division, which is part of Region 11 (www.justice.gov/ust/r11/index.htm), can be contacted at

Office of The United States Trustee
219 S. Dearborn St, Rm. 873
Chicago, IL 60604
312-886-5785
Fax: 312-886-5794

The UST's District Office for the Northern District of Illinois, Western Division, is covered by the UST for the Western District of Wisconsin, which is also part of Region 11 (www.justice.gov/ust/r11/index.htm), and can be contacted at

Office of The United States Trustee
780 Regent St., Ste. 304
Madison, WI 53715
608-264-5522
Fax: 608-264-5182

The UST's District Office for the Central and Southern Districts of Illinois, which is part of Region 10 (www.justice.gov/ust/r10/index.htm), can be contacted at

Office of United States Trustee
401 Main St., Ste. 1100
Peoria, IL 61602
309-671-7854
Fax: 309-671-7857

Finally, any Chapter 7 or Chapter 11 trustee, or counsel for any Chapter 11 debtor-in-possession, should be contacted to determine whether it intends to administer the property for the benefit of the creditors or is interested in entertaining an offer to purchase the property.

✓ **E-filing.** It is required for every pleading in each bankruptcy court in Illinois to be electronically filed. The documents to be filed are uploaded to the court's website (*e.g.*, www.ilnb.uscourts.gov for the Northern District of Illinois) and become part of the case file. In order to e-file, one must attend a training class and obtain a password. The password acts as a signature. Documents to be e-filed are submitted in PDF format. The e-filing system is available 24 hours a day 7 days a week.

## III. BUYER'S REMOVAL OF PROPERTY FROM BANKRUPTCY JURISDICTION

### A. [20.4] Tools for Removal

Absent a Chapter 11, 12, or 13 plan confirmation, there are three primary sections of the Bankruptcy Code that address removal of real estate from bankruptcy jurisdiction. 11 U.S.C. §363 provides a significant mechanism for the sale of real estate. If the property was subject to an executory contract at the time of the bankruptcy petition, 11 U.S.C. §365 is utilized. 11 U.S.C. §554 is the tool on which parties rely to compel a trustee or debtor to "abandon" property of no value. If the debtor is reorganizing under Chapter 11, 12, or 13, its confirmed plan generally addresses disposition of its real estate.

### B. [20.5] Selling Property of the Bankruptcy Estate

The trustee is authorized to sell property. Any sale not in the ordinary course of business, however, requires court approval. Accordingly, unless an operating debtor is in the business of buying and selling real property, the trustee generally relies on Bankruptcy Code §363 to sell real estate. See 11 U.S.C. §363; Fed.R.Bankr.P. 6004.

The trustee can either conduct an auction sale or negotiate with an individual purchaser and recommend a particular agreement to the court for acceptance. Unless the trustee has established procedures that do not require a contract, the buyer's counsel should present the trustee with a written offer to purchase.

In the opinion of the author, the buyer's counsel should incorporate bidding protections into the offer. These protections generally create a bidding advantage in favor of the initial offeror. These protections often include "breakup fees," "bid protection," and "expense reimbursement agreements." A breakup fee is a payment to the bidder if, through no fault of his or her own, he or she is not the successful bidder. Bid protection assures the initial bidder that the next offer that is considered by the trustee is greater than a certain amount. Expense reimbursement agreements entitle the bidder to reimbursement for actual expenses incurred in the event that he or she is not the ultimate purchaser. Although bidding protections are typical, the type and amount of such protections are subject to court approval. In order to acquire court approval, the buyer's counsel should ensure that the requested protection is reasonable.

In the event that the trustee and the buyer's counsel reach an agreement, the trustee accepts the offer, subject to court approval, after notice and hearing. However, the trustee may utilize the first acceptable offer as a "stalking horse" in an attempt to acquire higher bids for the property. The offeror thus must be prepared to increase the offer as needed at the hearing.

The successful bidder is entitled to clear title to the property, free and clear of all liens. The liens attach to sale proceeds as long as the terms of Bankruptcy Code have been adhered to. 11 U.S.C. §363(f) authorizes a sale of real estate free and clear of any interest in that property of an entity other than the estate if any of the following is met:

> **(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 the property is to be 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.**

*See Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC),* 391 B.R. 25 (B.A.P. 9th Cir. 2008) (court stated that 11 U.S.C. §363(f) did not provide grounds to sell encumbered property "free and clear" of all liens).

Only "parties in interest" may object to the entry of the ultimate sale order by appealing the order to the U.S. district court in which venue lies. A "party in interest," however, is one who is "directly and adversely affected pecuniarily" by the sale of the asset. *Kane v. Johns-Manville Corp.*, 843 F.2d 636, 641 (2d Cir. 1988). *See Holmes v. Silver Wings Aviation, Inc.*, 881 F.2d 939, 940 (10th Cir. 1989). Merely being an unsuccessful bidder does not create a right to appeal since an unsuccessful bidder is not "aggrieved."

> **Although the present Bankruptcy Code does not contain any express restrictions on appellate standing, courts have uniformly held that the "person aggrieved"**

**standard is applicable to cases under the Code.** *Kane, supra,* 843 F.2d at 642, citing *Cosmopolitan Aviation Corp. v. New York State Department of Transportation,* 763 F.2d 507, 513 (2d Cir.), *cert. denied,* 106 S.Ct. 593 (1985).

The buyer's counsel is advised to note that the trustee has the right to sell not only the estate's interest in the real estate but the interests of any coowners as well. Accordingly, if a single debtor files a bankruptcy petition, the interest of both the debtor and a coowner can be sold through the bankruptcy process. However, Bankruptcy Code §363(h) allows a trustee to sell the interests of coowners in property only if

**(1) partition in kind of such property among the estate and such co-owners is impracticable;**

**(2) sale of the estate's undivided interest in such property would realize significantly less for the estate than sale of such property free of the interests of the co-owners;**

**(3) the benefit to the estate of a sale of such property free of the interests of co-owners outweighs the detriment, if any, to such co-owners; and**

**(4) such property is not used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light, or power.**

Notwithstanding any offer tendered by the buyer's counsel, there are statutory protections granted to certain parties in interest. First, the buyer's counsel should be aware that the holder of a lien in the property is entitled to bid at a sale and to utilize its claim in the property as part of its purchase price, unless the court determines that cause exists for such "credit bidding" not to occur. See 11 U.S.C. §363(k). *But see In re Philadelphia Newspapers, LLC,* 418 B.R. 548 (E.D.Pa. 2009). In addition to having a valid lien in the real estate, to qualify for bidding, the lienholder must also have an "allowed claim" within the meaning of 11 U.S.C. §§502 and 506. Second, the holder of dower or courtesy rights, or a tenant in common, joint tenant, or tenant by the entireties, is entitled to purchase the sale property at the price at which the sale is to be consummated. 11 U.S.C. §363(i).

Because the trustee is attempting to maximize distribution to the debtor's unsecured creditors, it is the author's opinion that the higher or better the offer, the greater the likelihood of a successful acquisition.

### C. [20.6] Assumption/Rejection of Executory Contracts

11 U.S.C. §365(a) authorizes a trustee, subject to the court's approval, to assume or reject any executory contract or unexpired lease of the debtor. In order for this section to be utilized, the contract must be executory at the time of the petition. Although not a defined term in the Bankruptcy Code, the term "executory contract" has repeatedly been defined as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy:*

*Part I*, 57 Minn.L.Rev. 439, 460 (1973). If the seller has only to receive payments from the purchaser, Code §365 does not apply. *See In re Cox*, 28 B.R. 588, 589 (Bankr. D. Idaho 1983); *See also In re Bertelsen*, 65 B.R. 654, 655 (Bankr. C.D.Ill. 1986); *Health Science Products, Inc. v. Taylor (In re Health Science Products)*, 183 B.R. 903, 919 (Bankr. N.D.Ala. 1995) (in determining whether land sale contract was executory, court reasoned that "[s]ince a bona fide purchaser could only acquire rights in real property transferred by the debtor by virtue of state law, Section 547(e)(1)(A)'s 'apparent command is to test the effectiveness of a transfer, as against the trustee, by the standards which applicable state law would enforce against a good faith purchaser' ").

The reader is cautioned that Bankruptcy Code §365 distinguishes the rights of a party to a contract for the sale of residential real estate from the rights of a party to a contract for the sale of nonresidential real estate, the latter of which is beyond the scope of this chapter. See 11 U.S.C. §365; Fed.R.Bankr.P. 6006.

The trustee in a Chapter 7 case must assume or reject an executory contract or unexpired lease in residential realty within 60 days (or any extensions thereof) after the order for relief. The time of entry of the order for relief does vary. If the case is filed voluntarily, its commencement constitutes the order for relief (see 11 U.S.C. §301), as does the voluntary commencement of a joint case under a chapter of the Code (see 11 U.S.C. §302). However, entry of the order for relief is not automatic if the case was not voluntarily commenced. If an involuntary petition is not timely controverted, the court enters an order for relief against the debtor in an involuntary case. Otherwise, an order for relief is entered only after trial. See 11 U.S.C. §303(h).

If the trustee in a Chapter 7 case does not assume or reject an executory contract or unexpired lease in residential real estate within the statutory time period, the contract is deemed automatically rejected. Although there is no automatic rejection of a residential real estate contract by pre-confirmation inaction in the other chapters of the Bankruptcy Code, a party to such a contract may file a motion with the court seeking a date certain by which an assumption or rejection decision must be made. See 11 U.S.C. §§365(d)(1), 365(d)(2); Fed.R.Bankr.P. 6006.

If the trustee rejects a debtor's executory contract for the sale of real estate under which the purchaser is in possession, the purchaser has the option of treating the contract as terminated or remaining in possession of the realty. If the purchaser elects to treat the contract as terminated, or if the purchaser is not in possession and the contract is rejected, a lien on the debtor's interest in the property arises for the recovery of any portion of the purchase price paid. 11 U.S.C. §365(j); Fed.R.Bankr.P. 6006. Alternatively, if the purchaser remains in possession, all payments must continue to be made in accordance with contract terms, but the purchaser may offset against such payments post-rejection damages caused by the debtor's nonperformance. The rights of the purchaser are limited to the offset. 11 U.S.C. §365(i); Fed.R.Bankr.P. 6006.

If the executory contract presents an opportunity for the trustee to generate funds to the general unsecured creditors of the bankruptcy estate, the trustee, in all likelihood, does attempt to assume the contract. If assumption of the contract is financially burdensome to the creditor body, however, the trustee either rejects or abandons the obligation.

An individual debtor in a Chapter 7 case also has standing to assume a lease. The creditor may require the debtor to cure any default to the creditor before agreeing to the assumption of the lease. If the lease is assumed, then the debtor, not the estate, assumes the lease. There are specific requirements for the debtor to follow in order to assume a lease under 11 U.S.C. §362(*l*).

If the lease is one for the debtor's residence, then the provisions enacted under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub.L. No. 109-8, 119 Stat. 23, substantially change the ability of the debtor to assume the lease and limit the stay to allow the landlord to continue the eviction process. See 11 U.S.C. §362(b)(22). If the debtor is a residential tenant and an eviction action was filed in the 30 days before the bankruptcy filing, then the stay is not imposed if (1) the eviction was due to endangerment of the property or (2) for illegal use of controlled substances — so long as the landlord files a certification with the bankruptcy court that the eviction is for the above purpose and was filed within the time frame. If the eviction was not filed before the bankruptcy petition, the stay can be terminated if the landlord files a certificate that the debtor has endangered the property or there were illegal substances on the property within the preceding 30 days. See 11 U.S.C. §362(b)(23). The debtor may object to such certification using the procedure set forth in 11 U.S.C. §362(m).

NOTE: Landlords should exercise caution when evicting tenants whose property is subject to bankruptcy court jurisdiction. Even if the stay does not affect the eviction process, the debtor's belongings may be property of the estate. *See Ward v. Edwards,* No. 07 C 3159, 2007 WL 3046133 (N.D.Ill. Oct. 10, 2007).

### D. [20.7] Abandonment of Property

An "abandonment" releases property from the bankruptcy estate and revests it in the debtor. 11 U.S.C. §554 authorizes the trustee to abandon any property of the estate that is burdensome to the estate or of inconsequential value. *See Wallace v. Enriquez (In re Enriquez),* 22 B.R. 934 (Bankr. D.Neb. 1982) (holding that court approved abandonment of any scheduled property is irrevocable). Notwithstanding abandonment by the trustee, the reader is cautioned that continued state court litigation with the debtor may require modification of the automatic stay to avoid violation of 11 U.S.C. §363(a).

Although not frequently used as a removal tool, the buyer's counsel should be aware that a debtor may be motivated to file a motion to compel the trustee to abandon property to allow consummation of a sale of a residence in which there is no equity for the bankruptcy estate. The debtor may be motivated to take such action so that he or she is able to receive the homestead exemption to which he or she is entitled by Illinois statute. 735 ILCS 5/12-901, *et seq.;* Fed.R.Bankr.P. 6007. *See also In re St. Lawrence Corp.,* 239 B.R. 720 (Bankr. D.N.J. 1999), *aff'd,* 248 B.R. 734 (D.N.J. 2000); *In re Gibson,* 218 B.R. 900 (Bankr. E.D.Ark. 1997). Although a prospective purchaser of the property has no standing to compel the trustee to abandon the property, the debtor, as a party in interest, may request that the court order the trustee to abandon such property if it is burdensome or of inconsequential value to the estate.

Abandonment may also occur by trustee inaction. If the trustee fails to administer an asset that the debtor lists as property of the estate, that property is abandoned to the debtor upon case

closure. See 11 U.S.C. §554(c). Accordingly, it is possible for the purchaser to purchase scheduled real estate from the debtor if the trustee fails to administer it and the case is closed.

### E. [20.8] Business Judgment of Trustee or Debtor-in-Possession

The ability of the buyer's counsel to remove property from bankruptcy jurisdiction largely depends on the business judgment of the trustee or debtor-in-possession administering the case.

> **The usual test for determining whether the court should approve an application by the debtor or trustee to reject an executory contract is the "business judgment" test which involves simply a determination of whether rejection of the contract would benefit the estate.** *In re Yellow Limousine Service, Inc.*, 22 B.R. 807, 808 (Bankr. E.D.Pa. 1982).

*See also Sundial Asphalt Co. v. V.P.C. Investors Corp. (In re Sundial Asphalt Co.)*, 147 B.R. 72 (E.D.N.Y. 1992). By way of illustration, the Bankruptcy Court for the Southern District of New York lists three appropriate business reasons for rejecting an executory contract:

> **Proper business reasons for rejecting a contract include the following: (1) the contract is uneconomical to complete according to its terms, *In re RLR Celestial Homes, Inc.*, 108 B.R. 36, 43 (Bankr. S.D.N.Y. 1989); (2) the contract is financially burdensome to the estate, *In re Minges*, 602 F.2d [**38, 42 (2d Cir. 1979)**]; *In re Leibinger-Roberts, Inc.*, 105 B.R. [**208, 211 (Bankr. E.D.N.Y. 1989)**]; (3) rejection will make the debtor more attractive to a prospective purchaser or investor, *In re G Survivor Corp.*, 171 B.R. [**755, 759 (Bankr. S.D.N.Y. 1994)**].** *In re Riodizio, Inc.*, 204 B.R. 417, 425 (Bankr. S.D.N.Y. 1997).

## IV. LENDER'S REMOVAL OF PROPERTY FROM BANKRUPTCY JURISDICTION

### A. [20.9] Automatic Stay

As a general rule, an automatic statutory injunction against collection efforts against the debtor and property of the estate arises when a bankruptcy case is filed. This injunction is found at 11 U.S.C. §362 and is referred to as the "automatic stay." *See In re Daniel*, 404 B.R. 318, 322 (Bankr. N.D.Ill. 2009) (describing three kinds of collection activity stayed by 11 U.S.C. §362(a)). Although a case filing precludes the lender's counsel from continuing with collection efforts, this injunction can be modified.

Notwithstanding this general rule, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, substantially curtails the automatic stay and, in certain instances, prevents the stay from being automatically imposed. For these cases, the BAPCPA shifts the burden of proof to the debtor in order to establish the extent of the stay or its imposition altogether.

Two sections that introduce limitations on the automatic stay are 11 U.S.C. §362(c)(3) and 11 U.S.C. §362(c)(4). The first major limit on the automatic stay is §362(c)(3), which provides that (1) if an individual debtor filing a Chapter 7, 11, or 13 case was a debtor in no more than one other case pending within the preceding year and (2) if that preceding case was dismissed (for reason other than under the Chapter 7 means test of 11 U.S.C. §707(b)), then, with respect to any action taken, the stay terminates as to the debtor on the 30th day after filing. The phrase "as to the debtor" or "with respect to the debtor" has led a majority of courts to hold that the stay terminates only as to the debtor, but not as to the property of the estate, leaving the automatic stay as to any real property in place. *In re Jones*, 339 B.R. 360 (Bankr. E.D.N.C. 2006); *In re Johnson*, 335 B.R. 805, 806 (Bankr. W.D.Tenn. 2006); *In re Pope*, 351 B.R. 14 (Bankr. D.R.I. 2006). While the First Circuit Bankruptcy Appellate Panel agreed that "Section 362(c)(3)(A) provides for a partial termination of the stay," the B.A.P. declined to render a holding on the 30-day timing provision in §362(c)(3)(B). *Jumpp v. Chase Home Finance, LLC (In re Jumpp)*, 356 B.R. 789 (B.A.P. 1st Cir. 2006). A minority position holds that the stay terminates to the debtor and as to the property of the estate entirely after 30 days. *In re Jupiter*, 344 B.R. 754 (Bankr. D.S.C. 2006); *In re Curry*, 362 B.R. 394 (Bankr. N.D.Ill. 2007); *In re Daniel*, 404 B.R. 318, 324 (finding that explanation employed by court in *Jones, supra*, was "not workable."). The Bankruptcy Court for the Central District of Illinois affirmed its support of the minority interpretation, finding that

> **the phrase "with respect to the debtor" used in Section 362(c)(3)(A) is not intended to limit the breadth of a stay termination to the debtor or to (non-estate) property of the debtor, while continuing the protection of the automatic stay to property of the estate.** *In re Furlong*, 426 B.R. 303 (Bankr. C.D.Ill. 2010).

Several courts have limited this stay termination only to those creditors that have taken some action with regard to collecting the debt owed prior to the case filing. *See In re Paschal*, 337 B.R. 274 (Bankr. E.D.N.C. 2006). *See also In re Graham*, No. 07-62339, 2008 WL 4628444 (Bankr. D.Or. Oct. 17, 2008); *In re Stanford*, 373 B.R. 890, 893 (Bankr. E.D.Ar. 2007).

A debtor with one prior case within one year may extend the stay beyond 30 days until the end of the case on a motion that is heard, not just filed, before the end of the 30 days. The second case is presumed to have been filed not in good faith if the prior case was dismissed or a creditor modified the stay. The debtor must rebut this presumption by clear and convincing evidence. See 11 U.S.C. §362(c)(3)(C).

The second major limit on the automatic stay is §362(c)(4). This section states that the automatic stay does not go into effect at all when an individual debtor under any chapter had two or more dismissed cases within the preceding one-year period (so long as the dismissals were for reasons other than for 11 U.S.C. §707(b) means test abuse). A debtor with two or more dismissals in the preceding year may move to impose the stay in the first 30 days of the case by bringing a motion and showing a substantial change in the debtor's affairs since the dismissal of the "next most previous case." See 11 U.S.C. §362(c)(4)(D)(i)(III). Lenders and other creditors may find themselves in emergency hearings to impose a stay to stop any imminent collection actions. A creditor may obtain a "comfort order" if the stay is not imposed. See 11 U.S.C. §362(c)(4)(A)(ii).

Another limit on the imposition of the automatic stay is an in rem order, pursuant to which the stay does not go into effect on a parcel of real property for two years after the entry of the order, regardless of future bankruptcy filings. See 11 U.S.C. §362(d)(4). This relief requires a showing of the debtor's intent to "delay, hinder, and defraud." *Id.*

If a debtor files a case while he or she is ineligible to file a case because of a prior order barring a new case or if in the prior case a creditor had requested relief and the debtor thereafter voluntarily dismisses the case, then there is no stay imposed by the filing of the new case.

NOTE: Since the curtailment of the automatic stay was an entirely new concept introduced with the BAPCPA on October 17, 2005, lawyers are urged to monitor developing caselaw that impacts the existence of the automatic stay, the property to which it attaches, and the creditors that are affected.

### B. [20.10] Modification of the Automatic Stay

The Bankruptcy Code permits a lender to remove its property from the jurisdiction of the bankruptcy court. For removal by stay modification to occur, the lender must establish "cause" or, in the alternative, establish that the debtor lacks equity in the property and the property is not necessary to an effective reorganization effort. See 11 U.S.C. §362(d); Fed.R.Bankr.P. 4001. To expedite the removal process, the statute directs termination of the stay with respect to the moving party 30 or 60 days after stay relief is requested, depending on the parties' agreement or unless otherwise ordered by the court. 11 U.S.C. §362(e).

### C. [20.11] Stay Modification in a Chapter 7 Case

Chapter 7 provides for the "straight" liquidation of a debtor's assets, not the reorganization of its financial affairs. Therefore, since a Chapter 7 debtor's interest in real estate is not necessary for an effective reorganization, establishment of no equity in the property results in relief from the automatic stay. A possible exception from the granting of stay relief may occur if the court directs the payment of "adequate protection" as addressed at 11 U.S.C. §361. Since a lender is a "party in interest," the lender's counsel is free to prosecute a motion to lift the automatic stay.

### D. [20.12] Stay Modification When the Debtor Is Reorganizing

In contrast to Chapter 7, Chapter 13 provides the debtor with an opportunity to reorganize its financial affairs. (Chapters 11 and 12 also facilitate the debtor's reorganization.) Accordingly, a Chapter 13 debtor often attempts to cure its residential mortgage default through Chapter 13 reorganization. The Chapter 13 reorganization is effected by a "plan." The length of the plan is determined by whether the debtor has income above or below the median income of the state. Debtors with more than median income must commit to a five-year plan. See 11 U.S.C. §§1322(d), 1325(b)(4). The Chapter 12 debtor may, however, be successful in stretching its plan payments to exceed the five-year limitation of Chapter 13. See 11 U.S.C. §1221.

Frequently, in an attempt to save a home, an individual does file a Chapter 13 petition after entry of a judgment of foreclosure but before entry of an order approving the sale. The lender's

counsel must determine whether the debtor has rights in the property. If the debtor does have rights in the property, these rights constitute property of the bankruptcy estate, and a motion to modify the automatic stay must be prosecuted. If the debtor has no rights in the property, however, the lender's counsel may proceed with the collection effort against the property without running afoul of the automatic stay. Any proceeding against a debtor personally require modification of the stay, depending on the status of the stay under 11 U.S.C. §362(c)(3), as discussed in §20.9 above.

Under 11 U.S.C. §1322(c)(1), "a default with respect to, or that gave rise to, a lien on the debtor's principal residence may be cured . . . until such residence is sold at a foreclosure sale that is conducted in accordance with applicable nonbankruptcy law." In *Colon v. Option One Mortgage Corp.*, 319 F.3d 912 (7th Cir. 2003), the Seventh Circuit affirmed the bankruptcy court holding that a state foreclosure sale is presumptively in accordance with applicable non-bankruptcy law *unless* the sale suffered from one of four particular statutory infirmities that would render it void. Accordingly, the right of the Illinois debtor to cure a default expires upon completion of the foreclosure sale of the property and does not continue during the period between this sale and its judicial confirmation by the state court. *See also Snowden v. Litton Loan Servicing Inc.*, 356 B.R. 429, 434 (N.D.Ill. 2006) ("In other words, [11 U.S.C.] §1322(c)(1) allows a debtor to cure a debt on a home mortgage loan up to the time of the foreclosure sale, or up to the time allowed under state foreclosure law, whichever is longer."). Drawing on this principle, a debtor cannot cure defaults on a mortgage on property that is or can be protected during a bankruptcy. *See Wish I LLC v. Fifth Third Bank (In re Wish I LLC)*, No. 10-13076, 2010 WL 2026657 (Bankr. N.D.Ill. May 18, 2010) (slip copy). Additionally, the statute does not grant a debtor an "additional right to cure a default on the mortgage through the Chapter 13 plan if the debtor does not timely redeem." *In re McKenith*, 428 B.R. 462, 464 (Bankr. N.D.Ill. 2010), citing *Snowden, supra.*

As long as the debtor has rights in the property, the lender must establish cause or that the debtor lacks equity in the property and the property is not necessary for an effective reorganization in order to modify the stay as to that property. Since a Chapter 13 debtor is reorganizing, the lender whose collateral is subject to Chapter 13 jurisdiction has the greatest likelihood of success in removing the property from bankruptcy jurisdiction by alleging that cause exists for stay modification.

### E. [20.13] Debt Reaffirmation as Limitation on Removal

Notwithstanding the discussion in §§20.9 – 20.12 above, the debtor may elect to cure a default under an existing mortgage. Such an election requires a cure and a reaffirmation of indebtedness. See 11 U.S.C. §§524(c), 1124, 1222, 1322.

## V. [20.14] STRIP-OFF OF RESIDENTIAL MORTGAGES

Lien stripping of a residential mortgage is generally not allowed in a Chapter 7 case. Although the standard rule in bankruptcy is that a claim secured by a lien on property is secured "only to the extent of the value of the property on which the lien is fixed" (*United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 103 L.Ed.2d 290, 109 S.Ct. 1026, 1029 (1989)), the

stripping off of a consensual lien from a debtor's residence has been substantially curtailed by caselaw. In *Dewsnup v. Timm,* 502 U.S. 410, 116 L.Ed.2d 903, 112 S.Ct. 773, 778 (1992), the Court held that 11 U.S.C §506(d) does not permit a debtor to "strip down" a creditor's lien because the "claim is secured by a lien and has been fully allowed pursuant to [11 U.S.C.] §502." Accordingly, "[a]ny increase over the judicially determined valuation [of the property] accrues to the benefit of the creditor," since this is what the debtor and the lender bargained for. 112 S.Ct. at 778. Since the U.S. Supreme Court cautioned that the *Dewnsup* decision was limited to its facts, many courts have thereafter allowed a strip-off of wholly unsecured claims at the request of Chapter 7 debtors. However, the courts are split on how to treat strip-offs in a Chapter 7. *In re Talbert,* 344 F.3d 555 (6th Cir. 2003). *See also In re Pistritto,* No. 03-10245, 2005 WL 906370 (Bankr. D.Del. 2005); *Pomilio v. MERS (In re Pomilio),* 425 B.R. 11 (Bankr. E.D.N.Y. 2010). A strip-off is the removal of a wholly unsecured lien. Despite the split of opinion, the United States Bankruptcy Court for the Northern District of Illinois convincingly held that, in addition to strip-downs, the *Dewsnup* decision does apply to strip-off requests by Chapter 7 debtors. The court, in *In re Immel,* 436 B.R. 538 (Bankr. N.D.Ill. 2010), reasoned that *Dewsnup, supra,* is equally relevant and convincing when a debtor attempts to strip off — rather than merely strip down — an approved but unsecured lien.

Although the Court's holding in *Dewsnup* effectively ended lien stripping on a principal residence in a Chapter 7 case, mortgages that are completely "underwater" have been successfully stripped off in the Chapter 13 context. Specifically, in situations in which

> **the first lien on the Property exceeds the equity remaining in the home, [**the**] secondary lien is wholly unsecured, and its interests may be modified by the Chapter 13 plan, pursuant to §1322(b)(2). This conclusion is consistent with all six Courts of Appeals to have directly considered the issue, as well as two Bankruptcy Appellate Panels. *See Zimmer v. PSB Lending Corp.*, 313 F.3d 1220 (9th Cir. 2002); *Lane* [***v. Western Interstate Bancorp.***], 280 F.3d 663 [**(6th Cir. 2002)**]; *Pond v. Farm Specialist Realty,* 252 F.3d 122 (2d Cir. 2001); *Tanner* [***v. FirstPlus Financial, Inc.***], 217 F.3d 1357 [**(11th Cir. 2000)**]; *Bartee* [***v. Tara Colony Homeowners Ass'n***], 212 F.3d 277 [**(5th Cir. 2000)**]; *McDonald v. Master Financial, Inc.*, 205 F.3d 606 (3d Cir. 2000); *Domestic Bank v. Mann* [***(In re Mann)***], 249 B.R. 831 (B.A.P. 1st Cir. 2000); *Lam v. Investors Thrift* [***(In re Lam)***], 211 B.R. 36 (B.A.P. 9th Cir. 1997).** *First Mariner Bank v. Johnson,* 411 B.R. 221, 224 (D.Md. 2009).

The controlling statute in issue is 11 U.S.C. §1322 which provides:

> **(b) Subject to subsections (a) and (c) of this section, the plan may —**
>
> *** * ***
>
> **(2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims.**

The foregoing is commonly referred to as the "anti-modification provision" and is the language preventing mortgagors from stripping mortgages from their devalued residences. As anticipated, in *First Mariner Bank*, however, "[b]ecause second mortgages are rarely used to purchase a home, making wholly unsecured second mortgages subject to the antimodification clause would have at best a minimal impact in encouraging home building and buying." *McDonald, supra,* 205 F.3d at 613. *See also Bartee, supra,* 212 F.3d at 293 (explaining that because secondary lending is "targeted primarily at personal spending, allowing wholly undersecured second mortgages under the umbrella of the antimodification clause would be unlikely to positively impact home building and buying") and 212 F.3d at 224 (would "upset the delicate balance that Congress established between rights of purchase-money lenders and over-extended debtors").

**PRACTICE POINTER**

✓ Note, the statute does not prohibit modification of residential mortgages that serve as secondary collateral for business loans.

Several courts have found that *Dewsnup, supra,* does not necessarily apply to Chapter 11 cases since 11 U.S.C. §1129(b) contemplates the modification of lien rights of secured creditors in the context of a Chapter 11 plan confirmation and, therefore, lien stripping is permitted in a Chapter 11 reorganization. See 11 U.S.C. §1123(b)(5). *See also Johnson v. IRS (In re Johnson),* 386 B.R. 171, 178 (Bankr. W.D.Pa. 2008); *In re Pomilio supra.*

## VI. [20.15] PRE-DISCHARGE LOAN MODIFICATION

Over the past few years, the United States has endured a mortgage foreclosure crisis of unprecedented proportions. According to a study undertaken by the financial institution, Credit Suisse, by 2012 "one in every nine homeowners — and one in six households that have a mortgage — will lose their home to foreclosure." Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in a Bankruptcy,* 2009 Wis.L.Rev. 565 (2009), citing *Fixed Income Research, Foreclosure Update: Over 8 Million Foreclosures Expected,* Credit Suisse Foreclosure Update (Dec. 4, 2008), available at www.chapa.org/pdf/Foreclosure UpdateCreditSuisse.pdf. With unstable economic forecasts and a tightening credit market, pre-discharge loan modifications, as opposed to foreclosures, have proven to offer both lenders and borrowers an amicable way to preserve a relationship that has become troubled. Unlike a workout between a lender and borrower, a foreclosure leaves both parties in a less advantageous position. Foreclosures are generally less profitable for lenders, who are subsequently required to allocate time and expense to reselling the foreclosed property, and are also burdensome to borrowers, who lose not only payments made in satisfaction of the debt, but also the property itself.

The Bankruptcy Code prevents the modification of "a claim secured only by a security interest in real property that is the debtor's principal residence" in a debtor's Chapter 13 bankruptcy plan. 11 U.S.C. 1322(b)(2). *See also Nobelman v. American Savings Bank,* 508 U.S. 324, 124 L.Ed.2d 228, 113 S.Ct. 2106, 2110 – 2111 (1993). Similarly in a Chapter 11, "if the

mortgage at issue is deemed to be secured only by the Debtor's principal residence, the Plan may not modify the rights of the holder of the secured claim." *In re Arns,* 372 B.R. 876, 881 (Bankr. N.D.Ill. 2007). See 11 U.S.C. §1123(b)(5). However, "nothing prevents a secured creditor from consenting to the modification of its claim." *In re Smith,* 409 B.R. 1, 4 (Bankr. D.N.H. 2009). *See* 11 U.S.C. §1325(a)(5)(A). *See also Flynn v. Bankowski (In re Flynn),* 402 B.R. 437, 442 (B.A.P. 1st Cir. 2009). As alluded to by the court in *Smith, supra,* even though the Bankruptcy Code provides secured lenders with certain rights, creditors are free to waive these protections. A secured creditor also can agree to a modification incorporating the loan modification agreement as part of the plan of conformation under 11 U.S.C. §1323(a). *See Smith, supra,* Similarly, a creditor and debtor may modify the original loan agreement before its discharge, and enter into an agreed order pursuant to which the modified contract survives discharge. See Fed.R.Bankr.P. 4008.

## VII. [20.16] CONCLUSION

There are significant issues to be addressed by the real estate practitioner when the realty in which a client has an interest is subject to bankruptcy jurisdiction. The practitioner must first acknowledge that any property interest subject to bankruptcy jurisdiction cannot be transferred without permission from the bankruptcy court. Once the practitioner determines that the property is subject to bankruptcy court jurisdiction, an automatic stay protects that property from that creditor's collection efforts. The practitioner must then proceed to move for removal of the property from the court's jurisdiction. The necessary tools for removal depend on the nature of the interest and the value of that interest to the bankruptcy estate. The enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act created a need for a body of caselaw to explain if an automatic stay exists, for whom, and to what extent.

## VIII. APPENDIX

### A. [20.17] Bankruptcy Code Sections Addressing Real Estate

Sections of the Bankruptcy Code addressing real estate include, among others, the following:

1. §362 (automatic stay);

2. §363 (use, sale, or lease of property);

3. §365 (executory contracts and unexpired leases);

4. §543 (turnover of property by a custodian);

5. §544 (trustee as lien creditor and successor to certain creditors and purchasers);

6. §548 (fraudulent transfers and obligations);

7. §550 (liability of transferee of avoided transfer);

8. §554 (abandonment of property of the estate);

9. §1322 (contents of Chapter 13 plan); and

10. §1325 (confirmation of Chapter 13 plan).

## B. [20.18] Federal Rules of Bankruptcy Procedure Addressing Real Estate

The Federal Rules of Bankruptcy Procedure addressing real estate include the following:

1. Rule 2002 (notices to creditors, equity security holders, United States, and United States Trustee);

2. Rule 4001 (relief from automatic stay);

3. Rule 6004 (use, sale, or lease of property);

4. Rule 6006 (assumption, rejection, or assignment of executory contracts and unexpired leases);

5. Rule 6007 (abandonment or disposition of property);

6. Rule 7001 (sale of estate and coowner interest in property); and

7. Rule 9014 (contested matters).

## C. Forms

### 1. [20.19] Complaint To Avoid Transfer and To Sell Property Free and Clear of Liens, Claims, and Encumbrances

**FORM(S) AVAILABLE BY PURCHASING HANDBOOK OR BY SUBSCRIBING TO SMARTBOOKS® OR SMARTBOOKSPLUS.**

### 2. [20.20] Application of Debtor-in-Possession To Assume Executory Contract

**FORM(S) AVAILABLE BY PURCHASING HANDBOOK OR BY SUBSCRIBING TO SMARTBOOKS® OR SMARTBOOKSPLUS.**

### 3. [20.21] Offer To Purchase Real Estate from Trustee

**FORM(S) AVAILABLE BY PURCHASING HANDBOOK OR BY SUBSCRIBING TO SMARTBOOKS® OR SMARTBOOKSPLUS.**

### 4. [20.22] Motion of Debtor To Compel Abandonment of Real Estate by Trustee

**FORM(S) AVAILABLE BY PURCHASING HANDBOOK OR BY SUBSCRIBING TO SMARTBOOKS® OR SMARTBOOKSPLUS.**

### 5. [20.23] Motion To Modify the Automatic Stay (Chapter 7)

**FORM(S) AVAILABLE BY PURCHASING HANDBOOK OR BY SUBSCRIBING TO SMARTBOOKS® OR SMARTBOOKSPLUS.**

### 6. [20.24] Motion To Modify the Automatic Stay (Chapter 13)

**FORM(S) AVAILABLE BY PURCHASING HANDBOOK OR BY SUBSCRIBING TO SMARTBOOKS® OR SMARTBOOKSPLUS.**

### 7. [20.25] Required Statement To Accompany All Motions for Relief from Stay

On February 17, 2004, the U.S. Bankruptcy Court for the Northern District of Illinois issued a standing order that the official Required Statement To Accompany All Motions for Relief from Stay must accompany all motions to modify stay and that the most recent version of the form must be used. See www.ilnb.uscourts.gov/orders/General_Orders/Statement_of_Default_Order.pdf#search=%27required%20statement%27. The current version of the form is available and fillable at www.ilnb.uscourts.gov/forms/Official_Bankruptcy_Forms/LBF_Statement_for_Relief_from_Stay.pdf.

### 8. [20.26] Motion To Confirm Termination or Absence of Stay

**FORM(S) AVAILABLE BY PURCHASING HANDBOOK OR BY SUBSCRIBING TO SMARTBOOKS® OR SMARTBOOKSPLUS.**

### 9. [20.27] Motion for Entry of Agreed Order Approving Loan Modification and Request for Relief from the Automatic Stay

**FORM(S) AVAILABLE BY PURCHASING HANDBOOK OR BY SUBSCRIBING TO SMARTBOOKS® OR SMARTBOOKSPLUS.**

## D. [20.28] Bibliography

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