

The New Bankruptcy Act: Provisions Affecting Real Estate

By John C. Murray

© June 2005

Introduction

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“Act”), 2005 (P.L. 109-8), was enacted into law on April 20, 2005 and applies to all bankruptcy cases filed on or after October 17, 2005 (with limited exceptions as to certain provisions). The Act was debated for more than eight years in Congress, and constitutes the most extensive revision of the Bankruptcy Code since 1978. The goal of the Act is to streamline the Bankruptcy Code, speed up proceedings, limit abuses (the FBI estimates ten percent of filings involve fraud), and “level the playing field.” Approximately half of the Act’s provisions deal with business, not consumers, and at least 21 provisions relate in some manner to real estate. The following comments summarize the revised provisions of the Bankruptcy Code that should have the greatest impact on bankruptcy estates involving real property interests.

Section 51(B): Single Asset Real Estate

Under revised Section 51(B), “single asset real estate” means:

[R]eal property constituting a single property or project, other than residential real property with fewer than 4 residential units, that generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental

The amendment to Sec. 51B deletes the former \$4 million debt cap that applied to single asset real estate, and also excludes a debtor who is a “family farmer.” To qualify as single asset real estate, income must not be derived primarily from business operations at the property. The definition would exclude, e.g., hospitals, hotels, casinos, manufacturing facilities, and marinas. (See also the discussion, below, of amended Sec. 362(d)(3) regarding the time periods for filing a reorganization plan and the payment of interest with respect to a bankruptcy proceeding involving single asset real estate.)

Section 101(54): Transfer

The definition of “Transfer” is revised to mean: (A) the creation of a lien [new]; (B) the retention of title as a security interest; (C) the foreclosure of a debtor’s equity of

redemption; or (D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing or parting with (i) property; or (ii) an interest in property.

The major change is the new language stating that, for bankruptcy purposes, the creation of a lien is a “transfer.” This is generally in accordance with existing state law. *See, e.g., Bank Midwest v. Lipetzky*, 674 N.W. 2d 176, 181 (Minn. 2004) (“the plain and ordinary meaning of ‘transfer’ includes the grant of a mortgage”). *See also* BLACK’S LAW DICTIONARY (6th ed. 1990), which defines “transfer,” when used as a noun, to include:

The sale and every other method, direct or indirect, of disposing of or parting with property or with an interest therein, or with the possession thereof, or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings, as a conveyance, sale, payment, pledge, *mortgage*, lien, encumbrance, gift, security or otherwise. (Emphasis added).

The new language in Section 101(54), stating that a lien is a transfer, is in great measure a reaction to the concerns of the American Land Title Association (“ALTA”). The ALTA strongly urged that the creation of a mortgage lien or other security interest in real estate be deemed a “transfer” so that mortgage lenders and other lien holders would be exempt from the Bankruptcy Code’s automatic-stay provisions under Section 362 where notice of an undisclosed bankruptcy proceeding in another jurisdiction is not a matter of public record in that jurisdiction, and would be able to assert the “good faith purchaser” defense under Section 549(c) to the avoidance of such transfers. (See also the discussion of the amendment to Section 549, below.)

Section 362: Automatic Stay

There are fourteen amendments to Section 362, most of which are intended to discourage bad-faith repeat filings. Many of these amendments affect real estate.

Section 362(b)(18) is amended to broaden the types of property taxes and assessments that are excepted from the automatic stay’s prohibition of the creation of post-petition liens. The language now reads as follows (the new language is underlined):

[U]nder subsection (a) of the creation of or perfection of a statutory lien for an ad valorem property tax, or a special tax or special assessment on real property whether or not ad valorem, imposed by a governmental unit, if such tax or assessment comes due after the date of the filing of the petition.

A new subsection, Section 362(b)(20), provides that the automatic stay will not operate with respect to any act to enforce a lien against real property if an order for relief from stay was entered in a prior case under new Sec. 362(d)(4) (see below), for a period

of two years after the entry of such order (except that the debtor may move for relief based on changed circumstances or for other “good cause shown”).

Another new subsection, Section 362(b)(21), provides that the automatic stay will not operate with respect to any act to enforce any lien against or security interest in real property if the debtor is ineligible under Section 109(g) [which provides that no individual or family farmer may be a debtor if such individual was a debtor in another pending case at any time within the preceding 180 days and the case was dismissed because of willful violations of court orders by the debtor or the debtor requested and obtained a voluntary dismissal following a request for relief by a creditor from the automatic stay] to be a debtor or the present case was filed in violation of a prior bankruptcy court order prohibiting the debtor from being a debtor in another case.

Another new subsection, Section 362(b)(22), provides that a lessor under a residential lease may continue an eviction or unlawful detainer proceeding against the debtor-lessee if a judgment for possession has been obtained pre-petition.

Another new subsection, Section 362(b)(23), provides that the automatic stay will not operate with respect to a pending eviction action to obtain possession of residential real property leased by the debtor if possession is sought due to endangerment of the property or the presence of illegal controlled substances (but only if the lessor files with the court and serves upon the debtor-lessee a certification of such endangerment, or existence of controlled substances, within the 30-day period preceding the bankruptcy filing).

Another new subsection, Section 362(b)(24), provides that the stay will not operate with respect to any transfer that is not avoidable under Section 544 (Trustee as Lien Creditor and as Successor to Certain Creditors and Purchasers) and that is not avoidable under Section 549 (Postpetition Transactions). This amendment clarifies that a post-petition transfer of an interest in real property (including the granting of a security interest in real property), which is not subject to attack under Section 549(c) if the transfer is to a good faith purchaser for present fair equivalent value and without knowledge of the commencement of the debtor’s bankruptcy case, cannot be set aside by the trustee or debtor in possession and will not be considered a violation of the automatic stay. (See also the discussion, elsewhere in this article, of the amendments to Section 101(54) (Transfer) and Section 549). Under Section 544(a), the trustee or debtor in possession has the power, as of the commencement of the bankruptcy case, to avoid transfers and obligations of the debtor to the same extent as certain hypothetical creditors, i.e., the trustee or debtor in possession has the same avoidance powers as (1) a judicial lien creditor; (2) a creditor holding an execution returned unsatisfied; or (3) a bona fide purchaser of real property, whether or not such creditors or purchaser exist on the date of the bankruptcy filing. Section 544(b)(1) incorporates state law into the bankruptcy process and enables the trustee or debtor in possession to exercise the rights of creditors under state fraudulent transfer law to void any transfer of an interest of the debtor in property that is avoidable under applicable state law. New Section 362(b)(24) clarifies that if the avoidance powers set forth above are not available to the trustee or debtor in

possession with respect to a transfer under Section 544, the automatic stay will not operate with respect to that transfer.

Another new subsection, Section 362 (c)(3) (Discouraging Bad Faith Repeat Filings), provides that if an individual debtor's case under Chapter 7, 11, or 13 was pending but dismissed within the past year the automatic stay terminates, with respect to any action taken with respect to a debt or property securing such debt or with respect to any lease, 30 days after the new filing (other than a case refiled under a chapter other than Chapter 7 after dismissal under Section 707(b)), unless an interested party requests a hearing within such time period and demonstrates good faith. Bad faith is presumed if the debtor filed more than one case in the past year or failed to take certain actions required by the court or the Bankruptcy Code, including failure to provide adequate protection or perform the terms of a confirmed plan.

Another new subsection, Section 362(c) (4)(A)(i), provides that the stay will not go into effect if an individual has filed two or more bankruptcy cases within the past year that were dismissed (other than a case filed under Sec. 707(b)), and also provides that if a party in interest so requests, the court will issue an order confirming that no stay is in effect provided that if a party in interest, within 30 days of the bankruptcy filing, requests that the stay be imposed and demonstrates that the filing is in good faith the court may so order after proper notice and a hearing.

Section 362(d)(3) (Payment of Interest) is amended to provide that a lender with a claim secured by single asset real estate (see the discussion of the amendment to Section 51(B) above) may obtain relief from the stay unless, before the later of 90 days after bankruptcy filing or 30 days after the court determines that the case involves single asset real estate, the debtor has filed a reorganization plan with a reasonable possibility of being confirmed within a reasonable time or has commenced monthly payments (which may be made from rents generated from the property) at the nondefault contract interest rate on the value of the creditor's interest in the real estate (prior to this amendment, interest was payable at the current fair market value rate, which often involved an evidentiary hearing and disputed testimony).

New Section 362(d)(4) provides relief from the stay to a creditor with a claim secured by an interest in real property if the court finds the petition was part of a scheme to delay, hinder, and defraud creditors and involved either a non-consensual transfer of all or part of the debtor's interest in the property or involved multiple bankruptcy filings affecting the property.

Another new subsection, Section 362(l), provides that the provisions of Section 362(b)(22) (see discussion above) will apply on the date that is 30 days after the filing date unless, within such 30-day period, the debtor-lessee files with the court and serves on the lessor a certification that it has a right under applicable state law to cure the default, that it has cured the entire monetary default, and that it has deposited with the court any rent that would become due during the 30-day period after the filing date, in

which case the court may order that the rights of the lessor under Section 362(b)(22) will not apply.

Section 365: Assumption of Leases and Contracts; Defaults Based on Nonmonetary Obligations

Section 365(b)(1)(A) is amended to provide that an unexpired lease may be assumed notwithstanding the existence of a non-curable non-monetary default (other than a penalty rate or penalty provision). The lessor is entitled to compensation for the actual pecuniary loss resulting from such default. The lessee must cure a default caused by the failure to operate a nonresidential lease by resuming operation at and after the date of assumption.

Section 365(b)(2)(D) is amended to provide that Section 365(b)(1) does not apply to a default under a provision relating to any penalty rate or *penalty* provision relating to a default arising from any failure by the debtor to perform nonmonetary lease obligations. Before this amendment, Sec. 365 (b)(2)(D) stated that, with respect to the trustee's option to assume a lease or other executory contract entered into by the debtor by curing any defaults, the trustee's obligation to cure such default was inapplicable if the default was a breach of a provision relating to "the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under the executory contract or unexpired lease." This particular language had created an ambiguity that remained unresolved by the courts: Did the word "penalty" modify "rate," or "rate and provision"? This distinction is important because the sentence structure raised a legitimate question as to whether or not the exception was for penalty rates and provisions for non-monetary defaults only, or whether the intent was to include penalty rates for monetary defaults as well as penalty provisions for non-monetary defaults. If the language in Section 365(b)(2)(D) constituted an exception for non-monetary defaults only, the bankruptcy trustee would not be required to cure penalties imposed by default interest rates. The majority of cases hold that the trustee is not required to pay contractual penalty-interest rates *or* pay penalty provisions applicable to non-monetary defaults, and the amendment to Section 365(D)(2) has now ratified that interpretation. *See In re Claremont Acquisition Corp., Inc.*, 113 F.3d 1029, 1034 (9th Cir. 1997); *In re Walden Ridge Dev. LLC*, 292 B.R. 58, 67 & n.2 (Bankr. D.N.J. 2003); *In re Williams*, 299 B.R. 684, 686 (Bankr. S.D. Ga. 2003); *In re New Breed Realty Enters.*, 278 B.R. 314, 320 (Bankr. E.D.N.Y. 2002); *In re Vitanza*, 1998 Bankr. LEXIS 1497, at *21 n.44 (Bankr. E.D. Pa. Nov. 13, 1998). But these cases are not entirely clear as to whether a default interest rate is *per se* a prohibited penalty. Neither the Bankruptcy Code nor applicable case law defines "penalty." At least one case, *In re Phoenix Business Park Ltd. Partnership*, 257 B.R. 517 (Bankr. D. Ariz. 2001), indicates that a "penalty rate" means a rate that is punitive in nature and not merely a default rate that exceeds the contract rate.

Section 365(d)(4) (Executory Contracts and Unexpired Leases) is amended to extend the time to assume or reject a lease from 60 days (before the amendment) to 120 days (or confirmation of a plan, if earlier). The court can extend this time period for an

additional 90 days for “cause” (210 days total) but only the lessor can authorize further extensions, and the debtor-lessee can no longer extend the time to assume or reject leases beyond confirmation of the plan. The result of this amendment likely will be greater lessor leverage and more negotiations between the lessor and debtor-lessee (especially with respect to multi-site tenancies), based on the lessor’s goal of occupancy and control as oppose to the lessee’s goal of maximizing value and restructuring. A retail lessee may claim that to determine which locations are profitable and should be assumed, the business must operate at least during one “heavy selling” season, such as the Christmas holidays. Another result of this amendment is that the debtor-lessee may not have sufficient time to sell “designation rights;” which may affect the value of the property. (The debtor’s real estate often is worth more than its business.)

Under Section 365(f)(1) (Executory Contracts and Unexpired Leases), shopping center lessors are the beneficiaries of special protections. These special protections recognize the need of shopping center lessors to maintain the proper tenant “mix” to generate customer traffic, the interdependence of the tenants in providing different types of goods and services, and the importance of quickly determining whether the lease will be affirmed, rejected or assigned by the debtor-lessee. Section 365(b)(3) provides that, with respect to defaulted leases in a shopping center, the debtor-lessee’s right to assume or assign such leases is conditioned upon a heightened (as opposed to non-shopping center leases, which are covered by Section 365(b)(1)) standard for “adequate assurance of future performance.” Under Section 365(b)(3), “adequate assurance of future performance” includes assurance of financial condition and operating performance and maintenance of percentage rent, as well as lack of disruption of the tenant mix and compliance with the provisions of the lease, such as radius, location, use, and exclusivity. This subsection prohibits the debtor-lessee from conducting a new or different business, or assigning the lease to a lessee that would conduct its business in a manner inconsistent with the existing permitted use(s) of the space or the existing lessee mix or theme of the shopping center. Section 365(f)(1) is amended to provide that the requirements of Section 365(b)(3) take precedence over the “anti-assignment” provisions of Section 365(f)(1), which permit assignment of a lease notwithstanding any lease provision that prohibits, restricts or conditions assignment of the lease. Prior to this amendment of Section 365(f)(1), it was possible for a bankruptcy court to find that Section 365(b)(3) should be read in conjunction with Section 365(f)(1), so that the court would find unenforceable not only shopping center lease clauses that directly prohibit assignability, but also those provisions that are so restrictive in their scope and application that they constitute “de facto” prohibitions on assignment. (*See, e.g., In re Rickel Home Centers*, 240 B.R. 826 (Del. 1998), which held that the anti-assignment provisions of Sec. 365(f)(1) override the protections for shopping-center lessors provided in Sec. 365(b)(3). *Contra, In re Trak Auto Center*, 367 F.3d 237 (4th Cir. 2004)).

Section 503(b) (Priority for Administrative Expenses)

This section applies where a nonresidential lease is assumed and later rejected. Section 503(b)(7) is amended to limit the lessor’s priority administrative expense claim

for rental to two years following rejection of the lease or turnover of the leased premises (excluding penalty provisions or failure to operate), minus sums received from other parties. (Formerly, there was no such limit). Thereafter, the lessor's claim is unsecured and subject to Section 502(b)(6) cap (one year's rent or three years, not to exceed 15% of the remaining term). This subsection was enacted to counteract the decreased time frame available to debtor-lessees to assume or reject leases, as provided in the amendments to Section 365(d)(4) (see discussion above).

Section 522 (Limitations on Homestead Exemption)

New Section 522(p) limits the homestead exemption to \$125,000 for a residence acquired during the 1215 days (three years and four months) prior to a bankruptcy filing. (This limitation does not apply to the principal residence of a family farmer). There is no change to the unlimited homestead exemption in Florida, Texas, Kansas, Iowa, and South Dakota for homesteads acquired before the 1215-day period.

Pursuant to new Section 522(p)(1) and new Section 548(e)(1)-(2), the homestead exemption is reduced to the extent non-exempt property was fraudulently transferred by the debtor within ten years before the date of filing of the petition.

New Section 522(q)(1) also provides that if the debtor has been convicted of a felony or owes a debt arising from a violation of security laws, or certain other laws, the debtor cannot exempt any amount of an interest in property in excess of the \$125,000 cap, regardless of how long ago the debtor acquired the property. Section 522(q)(1) further provides that the \$125,000 limit does not apply to the extent the debtor's interest in the property is reasonably necessary for the support of the debtor and the debtor's dependents.

Section 523 (Exceptions to Discharge)

Section 523(a)(16) is amended to provide that if a debtor that is a member of a condominium, co-op, or homeowners association files under Chapter 7, 11, 12, or 13, the debtor is not discharged from the obligation to pay the regular fees due for such membership for as long as the debtor or trustee has a legal, equitable, or possessory interest in the condominium or co-op unit or a lot that is part of the homeowners association.

Section 524 (Discouraging Abuse of Reaffirmation Agreement Practices)

New Section 524(j)(3)(J) provides that court approval is unnecessary for a reaffirmation agreement of consumer debt secured by a mortgage; the document becomes effective upon filing with the court if the debtor was represented by an attorney (unless the reaffirmation agreement is deemed to be an undue hardship). New Section 524(j)(3)

also sets forth in detail the specific disclosures that the debtor must receive in writing before signing the reaffirmation agreement.

Section 547 (Preferences)

Section 547(b) is amended to overturn the “*DePrizio* rule.” In *Levitt v. Ingersoll Rand Finance Corp. (In re DePrizio)*, 874 F.2d 1186 (7th Cir. 1989), and its progeny, courts extended the preference rule from 90 days to a full year for non-insider creditors when the transfers in question nevertheless benefited an insider. (An insider is one who is a principal of, or related to, or affiliated with the debtor. 11 U.S.C. § 101(31)).

The 1994 Bankruptcy Code amendments revised Section 550 to prohibit recovery, from a non-insider creditor, of a transfer made for the benefit of an insider during the extended one-year “look back” preference period applicable to insider transfers. But the transfer could still be *avoided* under Section 547, and cases have so held. *See, e.g., In re Williams*, 234 B.R. 801 (Bankr. D.Or. 1999) (upholding claim of trustee that alleged preferential transfer, involving security interest of defendant in debtor’s mobile home, was for benefit of debtor’s wife, an insider, and that trustee could avoid perfection of security interest under “*DePrizio* rationale”); *Suhar v. Burns (In re Burns)*, 322 F.3d 421 (6th Cir. 2003) (ruling that Section 550 was not applicable to avoided mortgage because trustee had not sought recovery of any property or its value from mortgage lender). *Contra, Helbling v. Krueger (In re Krueger)*, 2001 Bankr. LEXIS 723, No. 98-18686, Adv. 99-1016 (Bankr. N.D. Ohio June 30, 2000).

Section 547(b) is amended to provide that a transfer made between 90 days and one year before the bankruptcy filing to an entity that is not an insider, but that results in a benefit to a an insider, is recoverable only from the creditor that is an insider and not from the creditor that is not an insider (including a lender to the debtor). This amendment should result in the greater willingness of lenders to permit loan guarantees by insiders of debtors. It also should eliminate “*DePrizio* waivers” in guaranty agreements, which prohibit an insider guarantor from becoming a creditor of the debtor’s estate (thus preventing, hopefully, avoidance of the lender’s lien). The amendment applies immediately, with respect to cases filed on or after April 20, 2005.

Section 547(c)(2) is amended to provide that in order to establish the “ordinary course of business” defense, the defendant need only demonstrate that the transfer was in payment of a debt incurred by the debtor in the ordinary course of business of the debtor and such transfer was (1) made in the ordinary course of business of the debtor and the transferee; or (2) made according to ordinary business terms (not both, as required before the amendment). This should avoid the necessity of obtaining expensive and time-consuming expert testimony regarding industry standards.

New Section. 547 (c)(9) provides that preference actions in non-consumer cases cannot be brought in amounts less than \$5000. Furthermore, Sec. 1409(b) of title 28, United States Code (Venue of Certain Proceedings), is amended to provide that an action

to recover a debt (other than a consumer debt) against a non-insider of the debtor that is less than \$10,000 must be brought in the district where the defendant resides; and the former \$5,000 threshold for recovery of consumer debt is increased to \$15,000. This should limit “nuisance” suits by trustees and decrease costs formerly incurred to appear in distant jurisdictions to defend preference actions.

Section 547(e)(2) (A), (B) and (C) are amended by extending the “safe harbor” statutory period for a secured party to perfect its lien (and obtain immunity from a preference attack by the trustee or debtor in possession) from ten days to 30 days. Security interests are voidable by a bankruptcy trustee or debtor in possession as preferential transfers if they were perfected within the preference period, and more than the applicable statutory period (formerly ten days), commencing after the security interest was granted. This change is consistent with the amendment to Section 547(c)(3)(B), which extends from 20 to 30 days the period during which the holder of a purchase-money security interest in the debtor’s property can perfect its interest and avoid a preference challenge under Section 547.

Section 548 (Fraudulent Transfers and Obligations)

Section. 548(a)(1) is amended to extend the “reach back” period for avoidance of fraudulent transfers from one year to two years. The amendment applies only to cases filed one year after date of enactment (April 20, 2005).

Longer “reach back” periods under applicable state fraudulent conveyance statutes still apply, because (as noted earlier) Section 548 incorporates such statutes into the bankruptcy process. Section 544(a) of the Bankruptcy Code gives the trustee or debtor in possession the status of a hypothetical lien creditor whose lien was perfected as of the date of the filing of the bankruptcy petition. Section 544(b) enables the trustee or debtor in possession to void any transfer of an interest of the debtor in property that is avoidable under applicable state law. For example, the Uniform Fraudulent Transfer Act, in effect in approximately 40 states, contains its own statute of limitations that extinguishes any claim not brought within four years after the transfer was made or the obligation was incurred. UFTA Section 9(a).

Section 549 (Postpetition Transactions)

Sec. 549(c) is amended to state as follows (the new language is underlined):

The trustee may not avoid under subsection (a) of this section [which permits a trustee to avoid a property transfer if it occurs after commencement of the case and is not otherwise authorized by the Bankruptcy Code or the court] a transfer of an interest in real property to a good faith purchaser without knowledge of the commencement of the

case and for present fair equivalent value unless a copy or notice of the petition was filed, where a transfer of an interest in such real property may be recorded to perfect such transfer, before such transfer is so perfected that a bona fide purchaser of such real property, against whom applicable law permits such transfer to be perfected, could not acquire an interest that is superior to such interest of such good faith purchaser.

Section 549 of the Bankruptcy Code governs postpetition transactions. Section 549(a) provides that a bankruptcy trustee may avoid a transfer of property of the estate made after the commencement of the case that is not otherwise authorized under the Bankruptcy Code or by court action. Section 549(c), however, provides that the trustee may not avoid such a transfer to a good faith purchaser without knowledge of the commencement of the case, where present fair equivalent value has been received by the debtor. The term “purchaser” is defined, in section 101(43), of the Bankruptcy Code, as a transferee of a voluntary transfer (the definition of “transfer” also includes an “immediate or mediate transferee of such a transferee”). But it is unclear whether a mortgage lender qualifies as a purchaser for the purpose of Section 101(43).

In *Thompson v. Margen (In re McConville)*, 110 F.3d 47 (9th Cir. 1997), *cert. denied*, 118 S.Ct. 412 (1997), the lenders made a mortgage loan to the debtors without specific knowledge that the debtors had previously filed a Chapter 11 bankruptcy petition. The trustee filed a complaint to avoid the lien of the mortgage as an unauthorized post-petition transfer under Section 549(a) of the Bankruptcy Code. The lenders argued that the lien could not be avoided because the mortgage was a transfer to them of real property and they were good faith purchasers without knowledge of the prior bankruptcy filing. The bankruptcy court agreed that the lenders were good faith purchasers, but held that the recordation of the mortgage violated the automatic stay of Section 362(a)(4) and that the lenders were not purchasers under the exception (for good faith purchasers for value without knowledge of the bankruptcy petition) created by Section 549(c). The lenders appealed to the district court, which held that the lenders were not “purchasers” within the meaning of Section 101(43) or Section 549(c).

The lenders then appealed to the Ninth Circuit Court of Appeals. The Ninth Circuit noted that both parties had “vigorously argued that the lien in favor of the Lenders was a transfer within the meaning of the bankruptcy code.” *Id.* at 49. The court further noted that the trustee had argued for avoidance of the transfer under Section 549(a), while the lenders argued that they qualified for the “good faith purchaser” exception under Section 549(c). Citing previous cases, the Ninth Circuit held that “whatever the abstract merits of these contentions, we find them both blocked by our precedents . . . which simply hold that the creation of a lien does not transfer property for purposes of section 549.” *Id.* See also *Jewell v. Beeler (In re Stanton)*, 248 B.R. 823, 828 (B.A.P. 9th Cir. 2000) (“Under Ninth Circuit authority, the postpetition creation of a lien on property of the estate is not a transfer of property for purposes of § 549”). The Ninth Circuit then found that the debtors had violated Section 364(c)(2) of the Bankruptcy Code, which

prohibits a debtor from obtaining secured post-petition financing without prior bankruptcy court authorization. The court ruled that rescinding the unlawful loan transaction was an appropriate remedy. However, the court also considered the equities of the case, noting on the one hand that the parties had stipulated that the lenders had acted in good faith and that the loan enabled the debtors to obtain the property for the benefit of the estate, but that on the other hand the lenders had to have known that the debtors' financial position was precarious and failed to take reasonable steps to determine the debtors' financial condition. Therefore, based on the equities of the case, the court limited the lenders' right of recovery from the proceeds of the sale of the property to the amount they had loaned less what they had already been paid on the debt, and granted the lenders a lien on the sale proceeds for that amount.

McConville is an important decision for mortgage lenders. If a mortgage were deemed not to be a transfer for purposes of Section 549(a) and the lender therefore was unable to rely on the "good faith purchaser" exception in Section 549(c), lenders would be justifiably afraid to make mortgage loans thereby "chilling" the availability of credit. The risk of subsequent avoidance of the transfer would be substantial in those instances where the borrower had previously filed bankruptcy in a jurisdiction other than that where the mortgage had been recorded, and such fact had not been disclosed to the lender or the title insurer by the borrower. It is virtually impossible for a mortgage lender or other party who advances funds to the debtor to search for bankruptcy filings in all fifty states at the time of closing. The purpose of Section 549(c) is to protect a good-faith innocent party who gives valid consideration to an unscrupulous debtor, where the party has no knowledge of, or reasonable means of determining, the existence of pending bankruptcy proceedings filed by or against the debtor. Section 549 has also served to protect the integrity of state recording statutes by protecting lenders, buyers, lessees and other parties who advance money based on the status of title to the property as disclosed by an examination of the property records in the county where the property is located and such parties are without knowledge of a bankruptcy petition by or against the debtor in another jurisdiction. As the district court noted in *McConville*, "[h]istorically, the section has been invoked when the real estate has been sold in a county outside of where the bankruptcy proceeding is pending." *Thompson v. Margen (In re McConville)*, 1994 U.S. Dist. LEXIS 18095 (Dec. 14, 1994), at *6.

It obviously is inequitable for the debtor to file for bankruptcy in another jurisdiction, obtain a mortgage loan secured by the debtor's property after failing to disclose the pending bankruptcy, and then avoid the mortgage lien. It also is inequitable, however, for the lender to make no attempt to ascertain the financial condition of the debtor or inquire whether there are any pending legal actions against the borrower prior to making the loan. The Ninth Circuit in *McConville*, at least with respect to the courts subject to its jurisdiction, obviated this analysis by holding that the creation of a mortgage lien is not a transfer for purposes of Section 549.

The ALTA reacted to this decision by proposing amendments to the Bankruptcy Code that would overturn *McConville* and modify Section 362(b) of the Bankruptcy Code to clarify that a post-petition transfer of real property required to be perfected under

Section 549(a) (and which would otherwise be immune from attack under Section 549) would be a valid transfer of a security interest in real property, and exempt from the Bankruptcy Code's automatic-stay provisions (under Section 362(a)), where notice of an undisclosed bankruptcy proceeding in another jurisdiction is not a matter of public record in that jurisdiction. The ALTA further suggested that Section 549(c) be amended to state that it applies to "transfers of interests in real property, including a security interest in real property," where the purchaser has given fair equivalent value without notice of a pending bankruptcy proceeding by or against the debtor and has timely perfected that interest. To further clarify that Section 549(c) applies to mortgages and other real estate encumbrances, the ALTA proposed that the definition of "transfer" in Section 101(54) be amended by inserting "the creation of a lien."

As amended by the Act, Section 549 now provides that the transfer of "an interest in" real property to a good faith purchaser for present fair equivalent value and without knowledge of the commencement of the debtor's bankruptcy case cannot be set aside by the trustee or debtor in possession. Also, the definition of "transfer" under Section 101(54) (see discussion above) has been amended to specifically include "the creation of a lien." Hopefully these changes will prevent future decisions, such as the Ninth Circuit's ruling in the *McConville* case, that refuse to acknowledge a mortgage lien as a "transfer" and thereby prevent the mortgage lender from asserting the "good faith purchaser" defense provided by Section 549(c).

Section 727(a)(8); Section 1328 (Extension of Period Between Bankruptcy Discharges)

Section 727(a) is amended to provide that the debtor cannot receive a further discharge in bankruptcy if the debtor has received a prior discharge of a Chapter 7 (liquidation) or Chapter 11 (reorganization) case during the eight-year period (formerly six years) preceding the date of the current petition.

Section 1328 of Chapter 13 (Adjustment of Debts of an Individual With Regular Income) is amended to provide that a debtor cannot receive a further discharge in bankruptcy if the debtor has received a prior discharge of a Chapter 7, 11, or 12 (Family Farmer) case during the four-year period preceding the date of the current petition or during the two-year period after a prior discharge under Chapter 13.

Section 1104 (Appointment of Trustee in Cases of Suspected Fraud)

New Section 1104(a)(3) provides that if even if grounds exist to convert or dismiss the case under Section 1112 (see discussion below), the court instead may order the appointment of a trustee if it determines that such appointment is in the best interests of the creditors and the estate.

New Section 1104(e) requires the U.S. Trustee to move for the appointment of a bankruptcy trustee if reasonable grounds exist to suspect that the debtor's governing body or key officers engaged in actual fraud, dishonesty, or criminal conduct in the management of the debtor or its public financial reporting.

Section 1112 (Conversion or Dismissal)

Section. 1112(b)(1) is amended to require the court to convert or dismiss the case if a party seeking conversion or dismissal establishes "cause" (prior to this amendment the court was permitted, but not required, to convert or dismiss the case), unless "unusual circumstances" demonstrate that such action is not in the best interests of creditors and the estate. Whether conversion, as opposed to dismissal, is granted by the court will depend on the "best interests" of creditors and the estate.

New Section 1112(b)(2) provides that conversion or dismissal will not be granted if the debtor or any other party in interest objects to the motion and there is a reasonable likelihood of plan approval, and the grounds that are asserted for conversion or dismissal involve actions by the debtor for which there is reasonable justification and that will be cured within a reasonable time.

New Section 1112(b)(3) provides that a requested hearing on cause must commence within 30 days of the motion, with a decision required not later than 15 days thereafter.

New Section 1112(b)(4) provides that "cause" includes: loss of the property's value and absence of a reasonable likelihood of rehabilitation; gross mismanagement; failure to maintain appropriate insurance; unauthorized use of cash collateral substantially harmful to the creditor(s); failure to comply with court orders; and failure to provide certain information and disclosures and pay taxes, fees, etc. (See also the discussion of Section 1104, above, which is amended to provide that if conversion or dismissal would not be in the creditors' best interests even though cause exists, the court may appoint a trustee or examiner.

Section 1121 (Period for Filing Plan Under Chapter 11)

Section 1121(d)(2) is amended to limit the debtor's exclusivity period to file a plan to 18 months (formerly 120 days; courts had routinely extended the exclusive-filing date in major cases numerous times for "cause"); the period for solicitation of acceptances is limited to 20 months (formerly 180 days). The court has no discretion to extend the exclusivity period for "cause" beyond the expiration of this time period.

Extensions of the exclusivity period often were used by debtors as leverage to obtain concessions from lenders and other creditors and as an aid in the negotiation of a

plan. The result of this amendment may be that more “distressed” sales of property and forced conversions and liquidations.

Expiration of the exclusivity period does not result in automatic dismissal or conversion, or inability of debtor to file and seek confirmation of a plan; but enables other parties in interest to file competing plans (including liquidating plans).

Section 1125 (Postpetition Disclosure and Solicitation)

New Section 125(g) permits the pre-filing solicitation of plan votes consistent with a “lock-up” agreement (a pre-petition agreement among creditors to vote in favor of the debtor’s pre-arranged plan filed post-petition; as opposed to a “prepackaged” Chapter 11 plan, which involves a plan that is solicited and approved post-petition). Under a lock-up agreement, creditors agree to vote in favor of a post-petition plan consistent with the pre-arranged terms of the lock-up agreement.

Under pre-existing law, debtors could not solicit votes post-petition until court approval of the debtor’s disclosure statement. *See In re NII Holdings, Inc.*, 288 B.R. 356 (Bankr. Del. 2002) (lock-up agreement bound creditor-signatories to vote for debtor’s reorganization plan; court ruled that votes to accept plan by creditors or interest-holders that signed lock-up agreement after petition date and prior to approval and circulation of disclosure statement would not be counted for purposes of determining acceptance or rejection of plan).

New Section 1125(g) should facilitate the post-petition confirmation of pre-arranged Chapter 11 plans. The new Section 125(g) amendment now allows solicitation of votes from creditors before commencement of the case and continued solicitation of lock-up agreements thereafter, but also provides that such solicitations must comply with non-bankruptcy law.

Chapter 15 (Ancillary and Other Cross-Border Cases)

New Chapter 15 adds 32 new sections to the Bankruptcy Code, and incorporates the Model Law on Cross-Border Insolvency (drafted by the United Nations Commission on International Trade Law).

Chapter 15 provides access to U.S. federal and state courts and relief for foreign debtors (and creditors) involved in cross-border insolvencies (including concurrent proceedings in both jurisdictions), and permits a foreign representative to file a petition for recognition of foreign insolvency proceedings in U.S. bankruptcy courts.

Chapter 15 also provides that a U.S. court can stay execution and collection on the debtor’s assets and provide other requested relief (subject to protection of creditors’ interests), such as providing for examination of witnesses and submission of evidence.

U.S judges also are given the power to turn over the assets of a debtor located in the United States for adjudication as part of a foreign proceeding.

28 U.S.C. 152(a) (Bankruptcy Judgeship Act of 2005)

New bankruptcy judges are appointed for 15 states and Puerto Rico; including four for Delaware, four for California, three for New York, and three for Maryland. The appointments are effective immediately, as of April 20, 2005. The appointments are “temporary,” i.e., if any new judge leaves due to death, removal, resignation or retirement after first five years following his or her appointment date, the vacant position will not be filled.

Conclusion

The Act, which contains more than 500 pages of legislation, does not contain any radical changes to the Bankruptcy Code with respect to its effect on residential and commercial real estate transactions. But it does clarify several issues that were the subject of different interpretations and conflicting federal court decisions. The Act also addresses some of the perceived abuses that were brought to light as the result of the recent filings of the largest business bankruptcies in history (including Enron and WorldCom). Many commentators believe that the Act tilts the playing field in favor of creditors, but this remains to be seen (the same comments were made with respect to previous revisions and amendments to the Bankruptcy Code).