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Feature

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The Mortgage Is Avoided, but What Is It Worth if the Debtor's Home Cannot Be Sold?

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A chapter 7 trustee successfully avoids an unrecorded mortgage on the debtor's home, and the avoided lien is "preserved for the benefit of the estate" under § 551 of the Bankruptcy Code. The value of the property does not exceed the total of secured debt plus the debtor's homestead exemption. However, can a trustee sell the property in order to realize the value of the avoided lien? This question concerning the "contours of a bankruptcy trustee's lien avoidance and preservation powers … when a debtor's state law homestead exemption has been invoked" was recently addressed by the First Circuit Court of Appeals in *In re Traverse*.[1]

The Holding

At the time of her chapter 7 filing, Virginia Traverse owned a home valued at $223,500. The home was subject to a first mortgage of $185,777 held by JPMorgan Chase and a second mortgage of $29,431 held by Citibank. The debtor claimed a state homestead exemption of $500,000,[2] which meant that the value of the exemption was $8,292, and no equity existed for general creditors. The debtor had been current on her mortgage payments and desired to keep the house. The trustee successfully challenged the JPMorgan Chase mortgage lien because it had been unrecorded and the lien was preserved for the benefit of the estate under § 551 of the Bankruptcy Code. At that point, the trustee sought to sell the property under § 363 of the Bankruptcy Code, expecting to realize the value of the avoided lien in cash because it would attach to the sale proceeds. In response, the debtor argued that the trustee should be limited to selling "only the mortgage itself."

The lower courts[3] both sided with the trustee. However, the First Circuit reversed, ruling that it is inappropriate for a trustee to sell a property where there is no equity available for unsecured creditors. However, for the avoidance action, the First Circuit observed that the debtor would have retained the property and continued to pay the mortgages, and the lienholders would have been powerless to foreclose absent a default. Preservation of the avoided lien gave the trustee an exclusive interest in the JPMorgan Chase mortgage lien, which could be sold as property of the estate; however, "if the underlying property has been exempted and withdrawn from the 'property of the estate' for the purposes of § 363, the preservation of a mortgage does not resurrect the trustee's § 363 powers over that property itself."[4] To hold otherwise would jeopardize the homestead exemption; the debtor's possessory interest in her home was not negated merely because the preserved mortgage, if paid, would realize an immediate benefit for general creditors. The First Circuit believed that its holding was fair because the debtor would wind up where she otherwise would have had the lien not been avoided, while the trustee would retain the ability to realize funds from either the value of the avoided mortgage, the proceeds of a sale of the home by the debtor or a foreclosure following a default.

It is easy to see why the First Circuit sympathized with the debtor's situation. Having maintained her mortgage payments in the expectation that she would remain in her home by continu-

1 *In re Traverse*, 753 F.3d 19, 22 (1st Cir. 2014).
2 *See* Massachusetts Homestead Act, M.G.L. c. 188, § 1, *et seq.*
3 *See In re Traverse*, 485 B.R. 815 (B.A.P. 1st Cir. 2013). The bankruptcy court's opinion was not published.
4 *Traverse*, 753 F.3d at 27.

ing those payments, she faced the loss of that home — not because of her own conduct, but because of her mortgagee's failure to record its mortgage. Had she never filed for bankruptcy and had JPMorgan Chase discovered its error, it simply would have taken the steps that were necessary to perfect its lien. That said, is *Traverse* sound, consistent and fair? If nothing else, the decision is highly problematic.

The Case Appears to Be Inconsistent with a Trustee's Right to Sell Property of the Estate

The trustee in this case was seeking to sell the property under § 363(b).[5] The realization of cash on account of the avoided lien would certainly be a sufficient justification supporting a sale outside the ordinary course. The trustee argued that he had the right to sell the property because the debtor's exemption was limited to a financial interest — not the property itself.

As a threshold matter, it is clear that the home became property of the estate under § 541(a) of the Bankruptcy Code because the debtor owned the fee title to it. It is equally clear that the debtor was entitled to claim Massachusetts's homestead exemption. Further, the First Circuit was correct when it noted that "a debtor's exempted property interests are effectively removed from the estate" and that "§ 363 does not empower the trustee to sell exempted interests."[6]

However, while the debtor's exempted interest in her home was removed from the estate, the home itself had not been. As the U.S. Supreme Court held in *Schwab v. Reilly*,[7] an exemption is an effort *to reclaim an interest in property* (in this case, it was the homestead amount) from the estate, leaving a trustee with the asset to sell, as property of the estate, when there is value to be derived from the property's disposition.[8] The court appeared to recognize the limited nature of the homestead exemption, yet it held that where a debtor's homestead equals or surpasses the net value of the property after its senior liens, the exemption protects both the "physical ownership of as well as her financial rights in her home," and thus the property may be excluded from the estate.[9]

Although the First Circuit recognized that a "core power of a bankruptcy trustee under § 363(b) ... is the right to sell 'property of the estate' for the benefit of the debtor's creditors,"[10] it nonetheless concluded that the trustee's hands were tied based on its narrow perception of "equity" in the property:

> Where ... a property fails to yield any remaining equity for the estate beyond the value of its secured encumbrances and the debtor's homestead exemption, a trustee generally should not sell the home, but should leave the secured creditors to their own legal means of recovering their claims.[11]

Having precluded the possibility of a sale under § 363(b), the First Circuit also confirmed that the trustee did not have the right to foreclose the avoided mortgage: "If ... a debtor continues to satisfy her contractual obligations to the benefit of the creditor, the mortgagee has no grounds to foreclose and the debtor may retain her home through the bankruptcy proceedings."[12]

The rule announced in *Traverse* — that a trustee should not sell property of the estate unless the purchase price exceeds the amount of all encumbrances and applicable exemptions — is nothing new, but what the First Circuit missed were the important exceptions to the rule. Those exceptions make it clear that a trustee can sell property in which the estate has no equity if the sale benefits unsecured creditors through an avoided lien or a carve-out. For example, the court in *In re Marrero* approved a trustee's decision to avoid a post-petition lien under § 549 whereby he intended to realize the value of the avoided lien through a sale of the property.[13]

In *In re Hannon*, the trustee avoided a subordinated tax penalty and thereafter sold the property so that he could realize the proceeds that were allocable to the penalty for the benefit of creditors.[14] Finally, in *Reeves v. Calloway*, the Fourth Circuit Court of Appeals authorized a sale under § 363(b) of fully encumbered property that was subject to a homestead whereby the trustee had obtained a carveout for the benefit of the estate.[15] The court's decision ignores these precedents and instead mischaracterizes the trustee's position as attempting to create "equity" in the property through lien avoidance. The trustee sought not to create "equity," but to create "value" for unsecured creditors through lien avoidance, and then, consistent with his duty under § 704(a) of the Bankruptcy Code, sought to realize that value by liquidating the property and distributing the proceeds.

Case Appears to Be Inconsistent with Purposes of § 551

As the First Circuit recognized, the purpose of § 551 is to "put the estate in the shoes of the creditor whose lien is [being] avoided" and to allow a trustee "to apply the value represented by [the] lien to the general estate, bypassing any junior lienholders."[16] The court appeared to believe that it was being fair to both the debtor *and* the general creditors by contemplating that the debtor would keep the home and pay the mortgages while the trustee would "enjoy the liquid market value of that mortgage, claim the first proceeds from a voluntary sale, or wait to exercise the rights of a mortgagee in the event of a default."[17]

Unfortunately, it is questionable whether the court's balancing act was successful, especially given the significant areas of uncertainty and the impact on the market value of the avoided lien if no § 363 sale is permitted.[18] For example,

5 Section 363(f) would also have permitted the property to be sold free and clear of liens and interests. The two liens would fall under § 363(f)(2) or, failing consent, § 363(f)(3). Since the Massachusetts homestead statute provides for the termination of the homestead upon a property's sale, the debtor's homestead interest would fall under § 363(f)(1).

6 *Traverse*, 753 F.3d at 24.

7 560 U.S. 770 (2010).

8 Section 551 provides that an avoided transfer is preserved "for the benefit of the estate but only with respect to property of the estate." *Traverse* would make little sense if property of the estate were not involved.

9 The court cited *In re Peirce*, 483 B.R. 368 (Bankr. D. Mass. 2012), which made it clear that the Massachusetts homestead exemption is not a possessory exemption and instead protects only the owner's interest in a home to the extent of the monetary exemption. *Id.* at 376.

10 *Traverse*, 753 F.3d at 24.

11 *Id.* at 25.

12 *Id.*

13 382 B.R. 861 (B.A.P. 1st Cir. 2008).

14 *In re Hannon*, 2014 WL 3385250, at 6 (Bankr. D. Mass. July 9, 2014).

15 546 F. App'x. 235 (4th Cir. 2013). *See also In re Scimeca Found. Inc.*, 497 B.R. 753, 782 (Bankr. E.D. Pa. 2013) (authorizing sale of fully encumbered property wherein trustee obtained a carveout); *In re KVN Corp. Inc.*, 2014 WL 3738655 (B.A.P. 9th Cir. July 29, 2014) ("Despite the general rule prohibiting the sale of fully encumbered property, chapter 7 trustees may seek to justify the sale through a negotiated carve-out agreement with the secured creditor.").

16 *Traverse*, 753 F.3d at 25 (quoting *In re Carvell*, 222 B.R. 178, 180 (B.A.P. 1st Cir. 1998)).

17 *Id.* at 31. A sale by the debtor will not necessarily pay off the lien because it might be done subject to the lien if the trustee cannot enforce any "due-on-sale" clause in the loan documents.

18 *Traverse* did not address another potential wrinkle affecting value: whether the avoided lien may be subject to the seniority of a later-acquired lien. *See In re DeLancey*, 94 B.R. 311 (Bankr. S.D.N.Y. 1988).

it is uncertain to what extent the trustee may step into the shoes of JP Morgan Chase so as to have both the note (*i.e.*, the debt) as well as the mortgage (*i.e.*, the lien) to enforce. In this regard, a number of decisions distinguish between the lien and the separate contractual rights of the lienholder, which was evidenced by the note, and call into question a trustee's power to exercise the mortgagee's remedies under an avoided mortgage, even where the mortgage is in default.[19]

Dicta in *Traverse* added greatly to the uncertainty over what rights travel with an avoided lien. In footnote 9, the decision raises, but does not resolve, the issue of what party is entitled to post-petition debt-service payments, stating that absent an agreement, avoidance and preservation of the mortgage lien "do not entitle the trustee to payments on the underlying debt."[20] If this were true, what would entitle the trustee to payment at any time other than in connection with a sale or refinancing by the debtor? How could the trustee ever hold the foreclosure right that the court identifies? Also, what meaningful value could any trustee realize from the sale of a lien under such an umbrella of doubt?[21]

The impact of *Traverse* on Massachusetts law (which governed the parties' substantive rights) is even more problematic; in fact, it is doubtful that the trustee could ever foreclose the mortgage, even if he could define a payment default. In 2012, Massachusetts's highest court ruled that foreclosure by exercise of a power of a sale can only be conducted by a person or entity "either holding the mortgage note or acting on behalf of the noteholder."[22] With the note in the possession of the original mortgagee — and with the debtor discharged from her obligations thereunder — the trustee's power to undertake any enforcement action with respect to the avoided lien is suspect and the debtor will have little incentive to cooperate. Thus, in reality, rather than balancing the competing interests of a debtor and her trustee, *Traverse* appears to have severely hampered a trustee's ability to derive value from an avoided mortgage, and potentially to have given the debtor a windfall: the ability to remain in her home without making further payments to anyone.[23]

Conclusion

At least in the First Circuit, where does *Traverse* now leave trustees when a mortgage lien on fully encumbered property that is subject to a homestead exemption has been successfully avoided? Sadly, the decision appears to be in a state of significant confusion and potentially leaves the trustee with no meaningful remedies to capture the true value for a debtor's unsecured creditors. Foreclosure of the avoided mortgage lien might not be an option, nor might the sale of the property under § 363(b).

A trustee might consider a sale of the mortgage, but the market for remedy-challenged liens is likely to be weak. A trustee might seek to reunite the mortgage note with the avoided lien by purchasing the note from the original lender — but the lender's price might be high, and one must question whether a trustee's rights as successor holder of an avoided lien are governed by the note, even if he holds it by assignment.[24] A deal with the debtor faces similar negotiating challenges. A trustee's sole option may be to keep the case open until the property is sold or refinanced by the debtor — which, given a debtor's disincentives, might not occur for quite some time. If *Traverse* is applied to circumstances involving a trustee's sale of encumbered property where a carveout has been negotiated, that avenue of value creation for creditors could also be equally jeopardized. It seems that a change in the law must await further word from the First Circuit or, in light of the conflicting approach taken by the Fourth Circuit in *Reeves v. Calloway*, possibly the Supreme Court itself.[25] abi

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19 *See, e.g., In re Haberman*, 516 F.3d 1207, 1209-10 (10th Cir. 2008); *In re Bremer*, 408 B.R. 355, 361 (B.A.P. 10th Cir. 2009), *aff'd sub nom., In re Trout*, 609 F.3d 1106 (10th Cir. 2010); *In re Brooks*, 452 B.R. 809, 816 (Bankr. D. Kan. 2011). In contrast, but at a more conceptual level, *In re Carvell*, 222 B.R. at 180, stated that preservation "does nothing to enhance (or detract from) the rights of that creditor [*vis-à-vis*] other creditors."

20 *Traverse*, 753 F.3d at 31.

21 The two cases cited by the court do not hold up well. *In re Rubia*, 23 Fed. App'x. 968 (10th Cir. 2001), solely involved a chapter 7 trustee's effort to reach payments made to the pre-petition lender (on an avoided mortgage) from the debtor's post-petition earnings, which were not property of the estate. The debtor had agreed with the trustee to pay him directly after the lien avoidance had been determined. *In re Trible*, 290 B.R. 838 (Bankr. D. Kan. 2003), which addressed avoidance and valuation issues, actually ordered the pre-petition lender to turn over a portion of post-petition payments based on an agreement to do so once a pro rata determination was made.

22 *Eaton v. FNMA*, 462 Mass. 569, 570 (2012).

23 The debtor in *Traverse*, presumably risk-averse, continued to pay the trustee the amounts that were due under the JPMorgan Chase note after the bankruptcy court's decision.

24 An alternative is for a trustee to settle with the lienholder, bringing funds into the estate that would net approximately what the litigation result would achieve for the unsecured creditors after taking into account costs, priorities and the lienholder's resulting unsecured claim.

25 On Sept. 16, 2014, the trustee in *Traverse* filed a petition for *writ of certiorari* to have the matter decided by the Supreme Court.