Bankruptcy Appellate Panel to Chapter 7 Trustees

"Carve-Out Agreements With Secured Creditors Are Presumptively Abusive"

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With Chapter 7 bankruptcy filings down significantly from recent years, it has been a difficult business climate for many Chapter 7 Trustees ("Trustee(s)" herein). A growing number of them are starting to generate business by attempting to "short sell" real properties that debtors surrender to their mortgage holders. A "short sale" occurs when a property is sold at a price lower than the amount the homeowner owes on the mortgage, and the homeowner's mortgage lender agrees to the "short" payoff.

In return for facilitating the "short sale," the Trustee negotiates a "carve-out" of the proceeds of the sale that would otherwise be applied to satisfy the secured creditor's lien. The "carve-out" is then distributed to the unsecured creditors of the bankruptcy estate, and the Trustee keeps a percentage of the distribution. This practice may be benign in cases where the secured creditor consents and the unsecured creditors gain a meaningful distribution. However, some Trustees have used coercive measures to obtain

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the secured creditor's consent. Such tactics of coercion include delaying the abandonment of fully secured real property and opposing the secured creditor's Motion for Relief from the Automatic Stay on trivial grounds, which has the effect of driving up litigation costs and changing the secured creditor's calculus in favor of allowing the Trustee to sell the property. In *In re KVN Corporation, Inc.* 514 B.R. 1 (9th Cir. B.A.P. 2014) ("*In re KVN Corporation*" herein), the Ninth Circuit Bankruptcy Appellate Panel ("BAP" herein) held that "short sale" agreements should be reviewed under a presumption of impropriety, but the presumption is rebuttable in appropriate circumstances.

The Facts

KVN Corporation, Inc. ("KVN" herein) owned a sporting goods store. In exchange for a $915,000 loan from Wilshire State Bank ("Bank" herein), KVN gave the bank a security interest in its real property and substantially all of its business assets. KVN thereafter filed for Chapter 7 bankruptcy protection. The value of KVN's secured assets was lower than the amount of the Bank's loan by the time KVN had filed bankruptcy.

The Trustee contacted the Bank and asked whether she could sell KVN's inventory, specifically firearms, in a transaction that would net between $4,200 and $4,400 for the unsecured creditors. The Bank agreed.

The Trustee requested the bankruptcy court's permission to proceed with this relatively benign and mutually beneficial transaction. However, the bankruptcy judge rejected it. The bankruptcy judge was reminded of a former Trustee that was convicted of embezzlement and who "had a habit of making deals with secured creditors even though there was no equity [in the property]…" The bankruptcy judge further opined that he did not believe that it was the appropriate role of the Trustee to sell fully encumbered property.[1]

Despite the Trustee's insistence that the transaction had the Bank's blessing and was fully disclosed, the bankruptcy judge denied the stipulation between the Trustee and the Bank to sell the property.

The Appeal

The Trustee appealed to the BAP. The issue on appeal was whether the bankruptcy court abused its discretion by denying approval of the stipulation to sell the fully encumbered property in exchange for a "carve-out" from the lien proceeds to the bankruptcy estate.

The BAP articulated the general rule that the sale of fully encumbered property is prohibited and runs counter to the Trustee's general duty to administer assets that provide a benefit to the bankruptcy estate and to immediately abandon assets that do not. *Id.* at 5. However, the BAP stated that there is no per se rule that prohibits "carve-out" agreements.[2] The BAP cited the United States Trustee's Handbook for Chapter 7 Trustees with respect to "carve-out" arrangements, which provides:

A trustee may sell assets only if the sale will result in a meaningful distribution to creditors. In evaluating whether an asset has equity, the trustee must determine whether there are valid liens against the asset and whether the value of the asset exceeds the liens. The trustee may seek a 'carve-out' from a secured creditor and sell the property at issue if the 'carve-out' will result in a meaningful distribution to creditors.... If the sale will not result in a meaningful distribution to creditors, the trustee must abandon the asset.[3]

Furthermore, the BAP found that there should be a presumption of impropriety for "carve-out" agreements based on past abuses and that such transactions need to be reviewed with heightened scrutiny.[4] To rebut this presumption, the BAP set forth the following inquiry: Has the trustee fulfilled his or her basic duties? Is there a benefit to the estate; i.e., prospects for a meaningful distribution to unsecured creditors? Have the terms of the carve-out agreement been fully disclosed to the bankruptcy court? If the answer to these questions is in the affirmative, then the presumption of impropriety can be overcome.[5]

The BAP vacated and remanded the bankruptcy court's ruling since the bankruptcy judge did not make this inquiry and summarily rejected the stipulation.

Coerced "Carve-Out" Agreements

Creditors should take extra precaution when filing Motions for Relief from the Automatic Stay in Chapter 7 cases where the real property has been surrendered by the homeowner. Such cases appear to

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be a target for "carve-out" attempts because the homeowner's exemption will not be an impediment to the sale of property. As previously mentioned, the Trustee may oppose the Motion for Relief from the Automatic Stay in order to use the automatic stay as leverage to negotiate a "carve-out" agreement. By doing this, the Trustee is betting that the secured creditor will provide its consent to the "short sale" in order to avoid bankruptcy litigation costs, which may be more than the secured creditor's cost to foreclose the property and sell it through its normal process.

If a creditor finds itself in this situation, *In re KVN Corporation* is a good case for the creditor's defense. It articulates the general rule that a Trustee may not attempt to sell fully encumbered property. It reiterates the Trustee's duties, including the fiduciary duty owed to secured and unsecured creditors alike, the duty to immediately abandon fully encumbered properties that are of nominal value to the bankruptcy estate, and the duty to insure and preserve estate property.[6] If these duties are not observed, then the Trustee is in violation of guidelines set forth by the United States Trustee Office.

Nevertheless, "short sale" agreements with Trustees may be mutually beneficial if the Trustee is able to offer an economically attractive alternative to foreclosure without engaging in tactics of coercion. Examples include unique expertise in selling a particular type of property, providing a discount to the commission that the Trustee's real estate broker will charge, and using lower priced vendors for escrow, title insurance, and so on. However, the transaction should be structured in a way that the primary benefit is for the creditors of the bankruptcy estate, not the professionals involved in facilitating the transaction. A small token "carve-out" for the unsecured creditors in an effort to make the transaction palatable for the bankruptcy court will likely be rejected.

Conclusion

In conclusion, the BAP got it right by holding that attempts by Trustees to sell fully encumbered properties should not be prohibited per se; however, such transactions should be reviewed with heightened scrutiny because they transcend the usual role of the Trustee. A secured creditor facing opposition from a Trustee in its attempt to obtain relief from the automatic stay should consider the possibility that the opposition is a pretext to negotiate a "short sale" agreement. With this realization, the secured creditor should either attempt to defeat the opposition by utilizing *In re KVN Corporation* or, if economically feasible, by working with the Trustee to structure a deal that will be beneficial for all creditors.

1 *Id.* at 3-4.
2 *Id.* at 4.
3 *Id.* at 6.
4 *Id.* at 7 (citing U.S. DOJ Exec. Office for U.S. Trs., Handbook for Chapter 7 Trustees at 4–14 (2012)).
5 *Id.* at 8.
6 *Id.*
7 *See* U.S. DOJ Exec. Office for U.S. Trs., Handbook for Chapter 7 Trustees (2012).

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the time of the eviction, the actual cost incurred by the Insured (less salvage value) for the Tenant leasehold improvements up to the time of the eviction. These costs can include zoning, building and occupancy permits, architectural and engineering fees, construction management fees, costs of environmental testing and reviews, and landscaping costs. All in all, the cost of obtaining the Leasehold title policies is minimal compared to the potential losses that could be insured by an uninsured tenant. Please feel free to contact GRS Title for a rate quote on Leasehold title polices for your next CRE tenant transaction.

NOTE: You should refer to the actual leasehold endorsement forms to obtain the actual wording and coverages as stated in the endorsements. Leasehold Endorsement forms are issued on American Land Title Association (ALTA) forms in most states, however there are also some states that use their own state specific forms, such as Texas, California, Florida, Pennsylvania, and New Jersey. This discussion is meant to be a very general, and not legal, discussion on certain aspects of the Leasehold Title Insurance. It is not intended to state the law of any particular jurisdiction, is not intended to be a full or complete discussion of the topic, and should not be used as the basis for any lawsuit or judicial interpretation.