

How to Approach Banks with Short Sales

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HOW TO APPROACH BANKS ABOUT SHORT SALES AND CARVE-OUTS

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1

“In reality, these debtor-trustee issues concerning a short sale are steeped in the highest tradition of bankruptcy - - what deal can be made that is in everyone’s best interest.”

In re Bonnie Jean Bunn-Rodemann,
491 B.R. 132 (Bankr.E.D.Cal. 2013)
(SARGIS, J.)

2

Background

- Normally, the administration of a bankruptcy estate is borne by the estate itself and not by secured creditors
- However, the Bankruptcy Code does not prohibit agreements where a secured creditor voluntarily agrees to pay professionals, or others, out of its collateral
- Although there are some similarities and overlap, a carve-out is distinguishable from a surcharge under 11 U.S.C. § 506(c) or a tax lien subordination under 11 U.S.C. § 724(b), neither of which requires any advance consent of the affected lien holder

3

Background

- Section 506(c) provides: “The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property.”
- Thus, the secured creditor can be forced to pay a surcharge under § 506(c) or can do so voluntarily for any agreed amount – in that sense it is like a carve-out, but without the upfront agreement

4

Background

- No carve-out exists unless ordered, or approved by the court with the consent of the affected secured creditor
- There is no reference in the Bankruptcy Code to “carve-outs,” and there is no established form for a carve-out agreement
- Therefore, it can mean different things to different people

5

Background

- The evolution of such agreements has come to include items such as:
 - (a) The amount being set aside
 - (b) How the fund should be applied, and
 - (c) Whether the fund’s continued availability is dependent on the occurrence or non-occurrence of a specific event
- Unless a carve-out agreement is reached with clear terms, a court is likely to find no agreement was ever reached absent the consent of the lender

6

Background

- Use a carve-out for the benefit of the bankruptcy estate (as opposed to professionals only) to create or increase the value available to the estate
- Mortgage holder gives up to the estate a certain amount of its lien position upon a sale of the property or properties in terms of an actual percentage, dollar realization, or combination of the two
- Carve-outs are also obtainable out of IRS liens, debtor exemption rights, and landlord claims
- An overlooked area of carve-outs is with business and real estate brokers

7

Former General Rules on Real Estate Carve-Outs/Surcharges With Lenders

- Rare in the typically small, residential, single-family property
- Exception: A commercial property or an extremely expensive residential property
- Compare the differences
 - The larger the debt the more likely the lender is to have a special assets officer or other specialist in charge of the account who can actually make a reasoned decision on behalf of the lender

8

Former General Rules on Real Estate Carve-Outs/Surcharges With Lenders

- The more valuable the property the greater reward
 - Each percent represents a greater amount of carve-out

9

Former General Rules on Real Estate Carve-Outs/Surcharges with Lenders

Whereas:

- “Smaller mortgages are more likely to be bundled into securities and later resold to investors with backing from Fannie Mae and Freddie Mac [who] will fine mortgage servicers that are found to be needlessly delaying the foreclosure process”.
WSJ 2/28/12
- “Low-end homes are being snapped up by investors and rented out at a profit. The market for high-end properties, though, is still sluggish, making banks wary of taking over [such] properties. WSJ 2/28/12

10

Former General Rules on Real Estate Carve-Outs/Surcharges With Lenders

- “Economists say banks are also more reluctant to foreclose on high-end properties because they are expensive to maintain and take longer to sell.” WSJ 2/28/12.
- There is also a smaller recovery to the estate
- This type of carve-out is usually successful when:
 - (a) Trustee is able to negotiate a specific amount that lender is able to accept below its payoff (perhaps because the loan has already been written down to that extent), and
 - (b) Trustee believes that the property can be sold for more than that amount plus costs of sale

11

Former General Rules on Real Estate Carve-Outs/Surcharges With Lenders

- In this type of carve-out, there can be a lot of risk on the trustee because of the time pressures that are usually imposed by the senior lender, but the payoff can be big, justifying the risk in the appropriate case

12

NEW General Rules:
LENDER PERSPECTIVE
363 Trustee Sale Benefits

- FAST – 60 to 90 days
- Avoids foreclosure and mediation delays
- Higher net payoff to lender
- Debtor (compare § 523(a)(16), estate and local neighborhood benefit)

13

NEW Issues:
363 Sale Impediments
- Lender Issues

- Lender does not respond to trustee inquiries
- Lender does not understand 363 trustee sales
- Lender does not understand a carve-out
- Internal training and compartmentalization
- Lender needs a BPO and a HUD statement
- Local counsel routine objections to sale motions

14

NEW Issues:
363 Sale Impediments
- Trustee Issues

- Trustee handbook, prohibition of selling secured assets
- “Meaningful” distribution
- Local UST Program opposition, no uniform policy
- Trustee local variances – lack of uniformity
- Judges have different approaches

15

NEW Issues:
363 Sales – Additional Issues

- How to arrive at carve-out amount
- “Buyer’s premium” instead of carve-out
- Prior court authorization – Nevada approach
- Lien stripping unsecured second liens in a sale
- Exemption questions
- Debtor cooperation

16

Does a debtor have a right to exempt the “carve-out” proceeds?

17

Most courts say NO

In re Bunn-Rodemann,
491 B.R. 132 (Bankr. E.D. Cal. 2013)

In re Baldrige, 2013 WL 1759365
(E. D. Mich. April 24, 2013)

In re Reeves, 2011 WL 841238
(Bankr. E.D. N.C. 2011 March 8, 2011)
aff'd (4th Cir. November 20, 2013)
546 Fed. Appx. 235 (4th Cir. 2013)

18

Contra - Debtor Can Exempt

- In re *Wilson*, 494 B.R. 502 (Bankr. C.D. Cal. 2013)

19

In re *Bunn-Rodemann*

- Court sustained Trustee's objection to debtor's claim of exemption in carve-out.
- Debtor's mere possessory interest did not entitle her the right to negotiate a short sale.
- Court says exempt property must exist on filing date.
- carve-out paid for Trustee's efforts, consistent with a surcharge under 506(c).
- Exemptions cannot be claimed against consensual liens under California law.
- Debtor may be able to negotiate with Trustee for his cooperation.
- If Trustee abandoned property, Debtor could negotiate directly with the creditor for a short sale.

20

In re *Baldrige*

- Affirmed denial of Debtor's claim of exemption in carve-out.
- Exemptions are subordinate to a secured creditor's lien under 522(c)(2). Thus, if there is no equity in the property, Debtor cannot claim an exemption.
- A carve-out is not property of the estate because it does not exist at the filing of the case.
- Debtor should not benefit from lienholder's voluntary agreement to pay a carve out from a short sale.

21

In re *Reeves*

- Trustee's motion to sell free and clear of liens was approved over Debtors' objection and a carve-out was allowed.
- Proposed sale was for the benefit of administrative costs and unsecured claims.
- Debtors' real property was subject to a mortgage lien and tax liens.
- The IRS agreed to a carve-out -- 30% of net proceeds from sale otherwise subject to the IRS lien. The Agreement was to pay allowed administrative expense claims and the balance would be shared pro rata with general unsecured creditors.
- Debtors were not entitled to payment on their claimed exemption before priority and unsecured claims because the Agreement was consistent with § 724(b) and Debtors' gifting argument failed in this chapter 7 context. carve-out was a result of the lien held by the IRS, not from a creditor who would be subject to Debtors' exemptions.

22

In re *Wilson*

- Debtor was entitled to wildcard exemption in carved out proceeds from sale of real properties by trustee.
- Court dismissed argument that because carve-out did not exist at filing, there could be no exemption.
- The asset upon which the exemption applied to was the properties and not the carve-outs themselves. The carve-outs were the means by which the estate acquired funds subject to the exemption.
- 363 sale is subject to all attached interests, including exemptions.

23

First Mortgage Carve-Outs

Hypothetical No. 1 (fixed dollar amount):

- Debtor is the sole member of an LLC
- The LLC owns a small commercial property
- The only debt of the LLC is the mortgage on that property of \$1.2 million
- The value of the property is estimated at \$1.25 to \$1.3 million
- The trustee is able to administer the LLC's asset as property of the bankruptcy estate
- **Carve-out:** Lender agrees to accept \$1,050,000 if the trustee can sell the property within 120 days and tender that amount; the estate gets any excess

24

First Mortgage Carve-Outs

Hypothetical No. 1 *(cont'd)*

- Trustee succeeds in selling within 120 days

Sale price	\$1,250,000
Less	
Lender amount	\$1,050,000
RE commission	\$ 75,000
Taxes	\$ 7,000
Estate retains	\$ 118,000
- Debtor's creditors paid in full

25

Consensual Surcharge & Realtor Carve-Outs

- Works with expensive properties without advance carve-out with lender but with advance carve-out with realtor of 2-3%
- Use where lender is unresponsive – so no advance carve-out possible, but you know the lender will greatly benefit from the sale and will ultimately consent

Hypothetical No. 1

- 1st mortgage..... \$2,050,000.00
- Fair market value appraisal.. \$1,200,000.00

26

Consensual Surcharge & Realtor Carve-Outs

Hypothetical No. 1 (cont'd)

- Sale price..... \$1,500,000.00
(363 sale motion filed without consent and stay relief motion pending)
- *Proposed surcharge..... \$ 45,000.00 (3%)
(Lender consented day before sale hearing)
- Realtor carve-out..... \$ 45,000.00 (3%)
- Furnishings..... \$ 10,000.00
- Total to estate..... \$100,000.00

27

Consensual Surcharge & Realtor Carve-Outs

- *Surcharge of \$45,000 is paid after property taxes, closing costs, realtor commission and capital gains tax (rare but big gain here, about \$150,000 of non-dischargeable taxes due – big help to debtors)
- Even in a down market a trustee must protect the estate from any tax liability

28

Consensual Surcharge & Carve-Out

Hypothetical No. 2

- Sale price.....
\$550,000.00
- Surcharge..... \$
27,500.00 (5%)
- Realtor carve-out..... \$16,500.00
(3%)
- Total to estate..... \$
44,000.00
- Short sale so no exemption attaches
- Lender consented night before the sale hearing

29

Lender Initiated Carve-Outs (Smaller Properties)

Hypothetical No. 1

- Scheduled value of home..... \$161,250.00
- Mortgage lienholder payoff..... \$150,000.00
- Sold for..... \$ 80,000.00
- Negotiated payoff to first..... \$
62,465.96
- Estate received..... \$ 10,000.00

30

Lender Initiated Carve-Outs (Smaller Properties)

Hypothetical No. 1 *(cont'd)*

- Mortgage Servicer initiated contact with the trustee requesting that she market and sell the property rather than Lender proceeding through judicial foreclosure
- Lender accepted the reductions in listing price and agreed to the contract price upon disclosure of disrepair and condition of home
- Trustee agreed to a commission of 33% of the carve-out received by the estate (\$3,333.33) in order to recognize a benefit to unsecured creditors

31

Lender Initiated Carve-Outs (Smaller Properties)

- Lenders are more motivated in judicial foreclosure states where it can take a year or longer to obtain a foreclosure judgment

32

Lender Initiated Carve-Outs **(Smaller Properties)**

Hypothetical No. 2

- Property's original scheduled value \$470,000.00
- First mortgage scheduled lien.....
\$252,080.00
- Second mortgage scheduled lien..... \$
70,042.00
(same lender as the first)
- Third mortgage scheduled lien..... \$95,832.00
(failed bank)

33

Lender Initiated Carve-Outs **(Smaller Properties)**

Hypothetical No. 2 *(cont'd)*

- Property listed quickly. The senior mortgage lender files for stay relief. Trustee did not show enough equity to oppose the motion but made a decision to continue with the property listing pending any foreclosure judgment (judicial foreclosure state)
- Ultimately trustee accepts a contract for \$325,000.00

34

Lender Initiated Carve-Outs (Smaller Properties)

Hypothetical No. 2 *(cont'd)*

- Lenders agree to the following payout:
 - Sale price..... \$325,000.00
 - First mortgage..... \$288,668.46
 - Second mortgage..... \$ 4,290.25
 - Third mortgage..... \$ 1,709.75
 - Bankruptcy estate..... \$ 9,000.00

35

Second Mortgage Carve-Outs

- Generally, when a senior mortgage is large and seeks stay relief to proceed with foreclosure, the junior mortgage is unwilling to protect itself
- Instead, the senior mortgage proceeds with foreclosure, credit bids its payoff, and junior liens are wiped out

36

Second Mortgage Carve-Outs

- The trustee can change this into a win-win situation by negotiating a carve-out with the junior mortgagee
- This would require the trustee to:
 - Oppose stay relief by the senior or reimpose the stay if it has already been granted
 - Sell the property
 - Pay off the senior liens, and
 - Preserve value for the estate according to whatever terms are negotiated

37

IRS Lien Carve-Outs

- The procedure for the IRS to foreclose its lien on a property is expensive, time-consuming, and cumbersome
- The IRS frequently will not take action to actually enforce or foreclose its lien against a debtor's property
- If there would be realizable equity in a property but for an IRS lien, negotiate a carve-out with the IRS so the property can be sold and both the estate and the IRS can benefit

38

IRS Lien Carve-Outs

- But where there are DSO or wage claims, first analyze whether § 724(b) (chapter 7 cases only) is more favorable to the estate
- If the property has no equity, the debtor's exemption rights will not come into play
- The trustee and estate benefit by standing in the shoes and position of a lien holder, and not by realizing on existing equity
- Debtor's exemption rights do not attach to the proceeds carved-out, surcharged, or subordinated

39

IRS Lien Carve-Outs

Hypothetical No. 1

- Debtor is sole owner of the property

Property value	\$200,000
Mortgage(s)	\$100,000
IRS Lien against property	\$250,000

- Carve-out:

The trustee opposes stay relief or reimposes stay, sells property, and bankruptcy estate retains first \$20,000 of net sale proceeds with the balance split equally between the IRS and the bankruptcy estate

40

IRS Lien Carve-Outs

- **Hypothetical No. 1** *(cont'd)*
- Property sells for \$200,000, less:
 - RE commission \$ 12,000
 - Property taxes \$ 3,000
 - Mortgage payoff \$100,000
 - Transfer taxes and other costs \$ 1,000
 - Net Sale Proceeds \$ 84,000
 - Estate gets \$20,000+\$32,000 \$ 52,000
 - IRS gets \$ 32,000
 - Conclusion – estate nets \$ 52,000

41

Conclusion

- The foregoing hypothetical situations are merely examples of carve-outs, consensual surcharges, and § 724(b) sales that can be achieved to benefit the bankruptcy estate
- However, the trustee should not put an inordinate amount of risk on herself unless the potential rewards will justify it
- The trustee must identify the appropriate case to attempt a carve-out or consensual surcharge or the trustee will find that she has wasted much time in a fruitless effort at chasing a carve-out or surcharge with a party who is not interested or where the estate cannot possibly benefit

42