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NEWS & PUBLICATIONS

SHORT SALES BY CHAPTER 7 TRUSTEES: A GROWING TREND

by Jeffrey L. Smoot

"The trustee will only sell non-exempt property that has equity... If a debtor owes more on any item of property than what it is worth ... the trustee does not even bother to sell [it]." The Standard Legal Law Library

Until recently, chapter 7 bankruptcy trustees did not sell property that had no equity. Homeowners who were "under water" on their homes could file chapter 7 with a measure of certainty that the bankruptcy trustee would not sell their home. If the home had no equity, there was simply no reason why a chapter 7 trustee would bother trying to sell it. Debtors could expect to stay in the home until it was eventually sold at foreclosure or a loan modification could be worked out with the lender. Recently, however, a growing number of chapter 7 trustees have begun to utilize a combination of § 363 and the short sale process to attempt to squeeze money out of real estate that would previously have been abandoned because it had no equity and was thus of no apparent value to the bankruptcy estate.

When a debtor files a petition for bankruptcy relief, an "estate" is created. 11 U.S.C. § 541(a). The estate is comprised of all of a debtor's legal or equitable interests in property. In chapter 7 cases, a trustee is appointed to administer the debtor's case, by collecting property of the estate, reducing it to cash, and distributing proceeds to creditors. 11 U.S.C. § 701, 702, 704. A chapter 7 trustee has a duty to investigate and recover assets for the benefit of unsecured creditors of the debtor. A trustee might perform this duty by filing a lawsuit to recover assets that were improperly transferred before the case was filed, or by selling one or more assets, including real property, if value can be recovered for the benefit of creditors.

In the spirit of granting honest debtors a "fresh start" through bankruptcy, debtors are entitled to exempt certain assets under applicable state or federal law. For example, in Washington, a debtor can exempt up to \$125,000 of equity in his or her "homestead" property (that is, the debtor's actual or declared residence) under state exemption laws or up to \$21,625 (\$43,250 for joint debtors) under federal exemptions. If there is equity in the debtor's residence that is claimed as a homestead, then the debtor will either get to keep the property because there is no equity value over and above the homestead claim, or at least receive the exempt amount in cash from a sale of the property by the trustee, money that the debtor can use to buy a new homestead property or otherwise keep a roof over his or her head. However, if there is no equity in the debtor's residence, such as when the amount of secured debt against the property exceeds its value (i.e., the home is "under water"), the debtor has no exemption to claim. However, because the property is property of the estate, it is still subject to the control of the bankruptcy trustee.

Traditionally, non-exempt real property that had no equity was abandoned by chapter 7 trustees because there was no benefit to the bankruptcy estate to be gained by selling it. In this topsy-turvy real estate market, this is no longer true. Even though there may be no equity in a debtor's residence, a chapter 7 trustee may still try to sell it for less than the amount of the total secured debt, with the consent of one or more of the secured creditors, who must agree to accept a price that is less than the amount they are owed.

For example, assume the debtor's house is worth \$700,000 but is subject to a deed of trust for \$750,000. The debtor is unable to claim a homestead exemption because the house is \$50,000 under water; there is no equity to exempt. But the chapter 7 trustee may still try to sell the house, because the trustee has the power to sell any asset of the estate under § 363 of the Bankruptcy Code. For the trustee to sell property that has no equity, the secured creditors must consent to a short sale—a sale that is short of the amount owed.

Why would a chapter 7 trustee bother with a short sale if there is no equity and the secured creditor would get all of the sale proceeds? Why would a secured creditor want to have the chapter 7 trustee sell the property?

What the trustee offers, in exchange for a percentage of the sale price or a buyer's surcharge, is a quick, clean sale of the property with minimal effort on the part of the secured creditor. A trustee in bankruptcy can sell property of the estate free and clear of liens and encumbrances under § 363. If the secured creditor has to foreclose, it may

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end up buying the property at a foreclosure sale, after many months of delay and considerable expense, and still have to sell the property if a third party does not buy the property at the foreclosure sale. On the other hand, if the creditor allows the trustee to do a short sale, the secured creditor gets cash out of the property without having to worry about the delay, expense, and paperwork of a foreclosure.

If, say, the lender agrees to pay the trustee 10% of the sale price on the above example, the trustee would make \$70,000 for the benefit of creditors on a short sale of our hypothetical property for \$700,000. Or the trustee may impose a surcharge on the buyer of the property to create value to the estate. For example, using our hypothetical, if the lender agreed to allow a sale for \$650,000, the trustee might list it at that price subject to a \$50,000 surcharge payable to the trustee in addition to the list price. From those funds, the trustee has to pay real estate commissions and legal fees (and the trustee's administrative fees), but by doing a short sale the trustee can effectively carve out money for creditors of the estate where no equity existed.

Trustees are not always successful in short sales. Secured creditors will usually set a target price that the trustee has to obtain for the property before a deal will be done. If that price is not met then a short sale is not approved. In that case, the asset would be abandoned by the trustee and the lender would eventually foreclose unless a loan modification or some other work-out was agreed to with the debtors. But if a short sale is approved by the lender and does succeed, the debtors—who expected to be able to stay in their home by either reaffirming the debt or continuing to pay or at least until the bank finally gets around to foreclosing—may find themselves looking for a new home much sooner than they expected.

This creative approach to creating estate assets for the benefit of creditors has also created uncertainty in the chapter 7 process for debtors, who can no longer rely on the old rule that trustee's don't sell property that has no equity. Chapter 7 trustees do sell property that has no equity, adding further insult to injury for many honest debtors who have already lost all of their equity through declining real estate values through no fault of their own.

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