Buyers Beware When Purchasing Distressed Property

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A record 1.58 million bankruptcy cases were filed in the United States in 2002, up 5.7 percent from a year earlier. According to the Administrative Office of the U.S. Courts, the bankruptcy boom is continuing in 2003. In the first two quarters of 2003, bankruptcy filings totaled 853,225. In addition to the increased bankruptcy filings, banks and financial institutions appear to be foreclosing on properties at an alarming rate. While specific data is not available on the actual number of foreclosures at this time, a cursory glance at the real estate section of The New York Times will reveal notices of foreclosure sale each day. Due to the surging rate of bankruptcies and foreclosures, fueled by a weak job market and lagging growth rate, a growing number of properties, both real and personal, have become available for sale in both bankruptcy and foreclosure situations.

These opportunities may present a way to realize a quick profit. However, a purchaser should be aware of various statutory requirements and risks prior to venturing into the purchase of a distressed property.

Process of Foreclosure

A foreclosure sale is authorized by the court when a borrower defaults on obligations secured by a mortgage and the lender forecloses on the property securing the loan. In addition to a situation involving a default on a mortgage, a foreclosure sale may be authorized in the event the property owner defaults on property taxes and a tax lien is entered by the government entity. After the entry of a tax lien, the governmental entity may commence an action to foreclose on the lien.

In each circumstance, the foreclosure sale will generally require judicial action, notice to all interested parties and a public sale. The public sale is intended to produce the best possible sale price. Real Property Actions and Proceedings Law (RPAPL) §4231(1) governs the notice and conduct of foreclosure sales.

A foreclosure sale is conducted by a sheriff of the county where the property is located or by a referee appointed by the court. To be appointed as a referee, a person may serve by consent of the parties, or be admitted to practice law in New York. In addition, notice of a foreclosure sale must be proper, as set forth in RPAPL §4231(2). Failure to properly notice the sale may result in the sale being set aside or the sale being void as to the omitted party. Notice of a foreclosure sale is given by publication in a newspaper, and by posting a copy of the notice of sale in three public places within the town where the property is located.

The referee appointed by the court selects the place, date and time of sale. The foreclosure sale is usually conducted on the steps of the courthouse where the judgment of foreclosure and sale was obtained. Since the sale is public, anyone can come and bid on the property. However, in order to bid, the purchaser must deposit with the referee a certified check or cash equal to 10 percent of the purchase price. The referee may require a greater down payment, depending on the circumstances surrounding the sale.

After the bidding is completed, the purchaser must pay the entire purchase price and take title to the property by a referee's deed. However, the referee has the authority to (and generally does) extend the time for the successful bidder to complete the purchase. Once the referee has filed his report of sale and the court has confirmed the report, the sale is complete.

Due Diligence

Generally, the prospective purchaser does not have the opportunity to inspect the property prior to the foreclosure auction. The property is sold "as is" and the purchaser does not have the opportunity to negotiate the terms of sale. The property is only sold at foreclosure "free and clear of liens" that are junior in priority and subject to proper notice. Therefore, it would behoove a prospective purchaser to undertake a thorough review of public records prior to bidding at a foreclosure sale. This will allow the prospective purchaser to determine whether the sale was being properly conducted and whether any liens will remain against the property.

The goal of the purchaser should be to purchase the property free of all liens. Unfortunately, however, some purchasers at foreclosure sales, especially those of small residential properties, do not undertake the necessary due diligence and, instead, rely upon their instincts prior to placing a bid on a foreclosed property.

The prospective purchaser should also review court documents to ensure that all parties with an interest in the property have been named. For example, in the event that the property being foreclosed is tenant occupied, the buyer should review the court documents to see if the tenant has been named as a party. If the plaintiff failed to join a tenant in possession at the property being foreclosed, the successful bidder may need to obtain possession by commencing a strict foreclosure action or a reforeclosure action.

A prospective bidder at a foreclosure sale should also be aware that liens in favor of governmental entities, including, but not limited to, federal income tax liens, property tax liens or assessment liens are “superpriority” liens and must be satisfied either out of the purchase price or otherwise borne by the purchaser. Taxes and assessments that were liens on the property at the time of sale are often satisfied out of the purchase price.

The successful bidder should ensure that the referee allocated sufficient funds for the satisfaction of the liens from the purchase price. Additional tax liens placed on the property subsequent to the auction sale but prior to the delivery of the deed must be borne by the purchaser. However, with respect to an IRS lien, a purchaser will be pleased to know that where a property that is owned by a husband and wife as tenants by the entirety and a tax lien is filed only against one spouse, the lien will not attach. Therefore, if a prospective purchaser is bidding on a property owned by both spouses, and the lien is only docketed as against one spouse, the purchaser will obtain the property free of that lien.

If property is acquired through a foreclosure of the first mortgage, all junior mortgages on the property are deemed removed as of record from the property provided that the junior mortgages are properly named and served in the foreclosure action. However, if the purchase is accomplished through a sale conducted by a second mortgagee, the first mortgage lien continues as against the property and must be satisfied (or otherwise dealt with) by the purchaser.

In the event of a foreclosure proceeding, the property owner has a statutory right of redemption that may be utilized anytime after the entry of judgment of foreclosure, but prior to the actual sale. How does this work? Under RPAPL §1341(2), the taxpayer must make a motion to stay the sale, and to make the requisite payment to the tax lien, to the court. New York courts have held that a mortgagor is afforded the right to redeem until the moment of the foreclosure sale. However, the statutory right to redemption has been interpreted strictly, and the failure to follow the procedure as set forth in the statute is not a defense.

Bankruptcy Proceeding

Often, on the eve of the foreclosure sale, the property owner will file a petition for relief under the Bankruptcy Code, effectively staying the foreclosure sale. Speculators who bid at foreclosure sales on a regular basis are aware of this possibility, which explains why they often fail to invest the time and do their homework prior to appearing at the foreclosure auction.

Once a bankruptcy proceeding is commenced, the mortgagee has two options. The first is to file a motion to seek relief from the automatic stay in the Bankruptcy Court where the petition was filed. The second option is to commence a dialogue with the bankruptcy trustee or the debtor to conduct a sale of the property under the aegis of the Bankruptcy Court. If the debtor has no equity in the property, the automatic stay should be lifted and the mortgagee may recommence or continue the foreclosure process. However, if the debtor has equity in the property, then the sale (should one occur) is conducted pursuant to the Bankruptcy Code.

Section 363 of the Bankruptcy Code provides the framework and the legal authority for a debtor or a trustee to sell property of the estate outside the ordinary course of business. A sale of commercial or residential real property, condominium unit, cooperative apartment or personal property is generally a sale outside the ordinary course of business. Where other parties own property together with the debtor, as a tenant in common, joint tenant or as tenant by the entirety, the property may be sold free and clear of the non-debtor's interests in the property if certain conditions are satisfied. More specifically, §363(f) of the Bankruptcy Code provides that the property may be sold if:

(1) applicable bankruptcy law permits a sale of such property free and clear of such interest;
(2) such entity consents;
(3) such interest is a lien and the price at which such property is being sold is greater than the aggregate value of all liens on such property;
(4) such interest is in bona fide dispute; or
(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.
Further, pursuant to §363(h) of the Bankruptcy Code, jointly held property may be sold by the trustee only if:

(1) partition in kind of such property among the estate and such co-owners is impracticable;
(2) sale of the estate's undivided interest in such property would realize significantly less for the estate than sale of such property free and clear of the interests of such co-owners;
(3) the benefit to the estate of a sale of such interest free and clear of the interests of co-owners outweighs the detriment, if any, to such owners.

The bankruptcy court may authorize the sale of jointly owned property if certain conditions are satisfied.

In order to sell property under the provisions of the bankruptcy code, the debtor or trustee must enter into contract with a prospective initial bidder, sometimes referred to as a "stalking horse." Once the contract is signed, must be submitted to the court for approval, upon no less than 20 days notice to all creditors and parties in interest. The approval hearing is a public auction for the purchase of the property on the same terms and conditions as set forth in the contract of sale with the initial bidder, except other parties may bid to a higher or better offer.

In the event that a party other than the initial bidder is the successful bidder, the initial bidder, or the "stalking horse," is often entitled to a "breakup fee" previously negotiated between the debtor and the initial bidder and made a part of the contract of sale approved by the court. The break-up fee compensates the stalking horse for expenses it undertook to prepare the initial bid and negotiate with the debtor.

The only circuit to have recognized and discussed the various approaches to break-up fees in bankruptcy is the U.S. Court of Appeals for the Third Circuit in *In re O'Brien*. The *O'Brien* court recognized three approaches to analyzing the value of break-up fees to the estate: (i) the business judgment rule; (ii) a "more searching review"; and (iii) a standard akin to §503(b) of the Bankruptcy Code. The Bankruptcy Court for the Southern District of New York has adopted the business judgment rule. For example, in *In re 995 Fifth Avenue Associates, L.P.*, the court held that when reasonable in relation to the bidder's efforts and to the magnitude of the transaction, breakup fees are generally permissible." While courts have adopted differing approaches in addressing break-up fees, they are generally expected and usually authorized by the bankruptcy court, so long as they are reasonable.

Condition of Property

In theory, under §363 of the Bankruptcy Code, the property is sold "free of liens, claims and encumbrances" with such liens, should they exist, to attach to the proceeds of sale. As a result, the purchaser is deemed to have obtained the property with a clean bill of health. However, after placing a bid, the purchaser is deemed to have knowledge of the condition of the property, and cannot rescind the contract or obtain a refund because of unexpected conditions associated with it. For example, in *re Oyster Bay Cove*, the district court held that the trustee was entitled to retain the deposit tendered by the successful bidder when the bidder failed to appear for the closing.

The bidder's argument that a road and storm drain that ran through the property constituted a defect in the title and would not allow the trustee to grant marketable title was held to have no merit. The district court affirmed the bankruptcy court's holding that "a sale 'free and clear of liens and other interests' has no impact on restrictions of record that run with the land."

One of the earlier cases dealing with this issue is *In re 523 Fifth Street Housing Preservation and Development Fund Corp.*, in which the debtor moved to sell real property free and clear of liens, encumbrances and covenants, including the restrictive covenant requiring that the property be used solely for low-income housing. The court held that the restrictive covenant ran with the property and could not be voided. Therefore, a prospective purchaser of property subject to bankruptcy auction should be aware that “free and clear of liens” does not mean that the property will be free and clear of covenants or easements that run with the property.

The purchaser should also be aware that a “sale free and clear of liens, interests and encumbrances” does not include taxes that were not assessed at the time of sale. For example, in *Vardtal v. City of Minneapolis*, the district court, in reversing the bankruptcy court, held that a bankruptcy sale was not free and clear of the pre-petition claim for unpaid water taxes that were assessed on and became a tax lien on the property after the sale was consummated. In addition, a postpetition tax that became a lien on the property after the bankruptcy was filed will not attach to the proceeds of sale, and will remain a lien on the property.

In practice, a successful bidder should be aware that prior to closing, a title company will require a certified copy of the bankruptcy court order authorizing the sale. The form of deed transferring title pursuant to a court-authorized bankruptcy sale is a bare bones “Trustee’s Deed,” which does not contain any warranties, covenants or comfort language for the purchaser.

Taxes and Good Faith
A purchaser should also be aware that under the Tax Law of the State of New York, conveyances made under the “Federal Bankruptcy Act” are exempt from New York State transfer tax. However, under New York City Transfer Tax regulations, a transfer made on account of a bankruptcy sale is exempt only when the transfer is made pursuant to a confirmed Chapter 11 plan. If the sale is not pursuant to a Chapter 11 plan, the transaction is taxable. The U.S. Court of Appeals for the Second Circuit has held that the New York State Gains Tax is an income tax and is therefore taxable like any other transfer. Therefore, sale of property through a bankruptcy sale will be (i) exempt from New York State Transfer Tax and (ii) subject to New York City Transfer Tax and New York State Gains Tax.

A property sold pursuant to the bankruptcy process is subject to capital gains tax. Any gain recognized is included as part of the bankruptcy estate. Although the capital gains tax is usually not the purchaser’s responsibility, the purchaser should watch out for the clever sale order that may direct the purchaser to pay the tax. Any recognized gain is subject to capital gains tax to the extent that the capital gains tax exclusion is not claimed by the debtor or the trustee on behalf of the estate.

Finally, a purchaser of property at a bankruptcy auction should know that it is subject to the good faith provisions of §363 (m) of the Bankruptcy Code. Although the Bankruptcy Code does not define a "good-faith purchaser," the courts have usually adopted the definition of "one who purchases the assets for value, in good faith and without notice of adverse claims." The court will make a finding of good faith from the purchaser's conduct during the sale proceedings. A finding of good faith is routinely made by the bankruptcy court at the time of the sale. However, if there is a finding of collusion, fraud or attempt to take advantage of the other parties, the bankruptcy court will not approve the sale. Additionally, the sale may be set aside on appeal if the district court makes a finding that the purchaser did not act in good faith.

Personal Property

Opportunities also exist to purchase distressed personal property sold under Article 9 of the Uniform Commercial Code. Personal property includes cooperative apartments as well as inventory, equipment, general intangibles and other personalty. Although this article has not addressed Article 9, suffice it to say that purchasers are advised to perform appropriate due diligence and to exercise caution when bidding on assets subject to secured party sales.

While it may appear that there are fortunes to be made from the purchase and resale of distressed properties, a prospective purchaser should always conduct due diligence prior to bidding at an auction, whether it be a foreclosure or a bankruptcy sale, and should also be familiar with the statutory peculiarities of both. To ensure that a profit is made and a fortune is not lost, the purchaser should search the title to the property, determine the priority of liens, attempt to negotiate the payoff of liens for lesser amounts and obtain title insurance on the property. While adopting these safeguards will not guarantee a windfall to the purchaser, due diligence is what separates the savvy long-term investor from the novice one-time buyer.

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