Another View: Trustee Sales in First Circuit

By David G. Baker

The First Circuit’s decision in In re Traverse has resulted in confusion and consternation because it dramatically reorders the relationship between trustees and debtors, particularly in chapter 7 cases. In essence, the First Circuit held that when a trustee avoids an unperfected lien and preserves it for the benefit of the estate, all that the trustee can sell is the lien itself — not the property — when there is no equity available over the perfected liens and the debtor’s exemption.

Indeed, the court in Shubert, supra, stated at a subsequent hearing in that case that “[c]verybody’s scratching their heads over Traverse.” As might be predicted, as Virginia Traverse’s attorney at all litigation stages of the case (but not the underlying bankruptcy case), the First Circuit got it exactly right, and in doing so, correctly applied both state and bankruptcy law to the facts before it.

In his article in the November 2015 issue, Edmond J. Ford of Ford & McPartlin, PA (a chapter 7 trustee) suggests that the First Circuit cannot mean what it appears to say in Traverse. On the contrary — the decision was true to the statutory language, which, of course, is always the starting point in statutory interpretation. As the First Circuit said, § 544 allows a trustee to avoid an unperfected lien and § 551 preserves it for the benefit of the estate, but the avoided lien (and its value) is all that the trustee receives.

The fundamental legal principles are not complex, but apparently have been misunderstood for so long that the error has become ingrained in courts’ and trustees’ thinking about the issue. Properly understood, the question is not whether the trustee may sell property, but what is the property that may be sold. Phrased that way, the answer is obvious: The trustee can only sell property of the estate.

The logical error stems from the conflation of “the property” with “the debtor’s interest in property.” Pursuant to 11 U.S.C. § 541(a), only “interests of the debtor” come into the bankruptcy estate as of the petition date; some other interests (such as the recovery of preferences or an avoidance of unperfected liens) only come into the estate later, if at all. Elsewhere in the Bankruptcy Code, the statutes also speak of “interests” in property. The U.S. Supreme Court itself has consistently spoken of “interests” in property. Thus, it is incorrect to speak of “the property” coming into the estate. This is true even if there are no liens or encumbrances on the property, as this would mean only that the value of the debtor’s interest is equal to the property’s fair-market value.

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Where there are other entities with interests in the property, those other interests do not come into the estate on the petition date. They can be brought into the estate pursuant to a trustee’s “strong-arm” powers under Part V of the Bankruptcy Code, but those property interests are separate and distinct from the debtor’s interest.

The Code permits a debtor to exempt his/her interest in the property, pursuant to § 522. An exemption withdraws the debtor’s interest from the bankruptcy estate, which means that the trustee cannot administer or liquidate the debtor’s interest since he/she no longer owns or controls it. As Schwab makes clear, a debtor must be sure to claim the maximum dollar amount legally possible, and it is only the unencumbered, nonexempt value of the debtor’s interest that can be administered, aside from any other interest in the property recovered by the trustee.

With this background, Traverse becomes more comprehensible. The value of Traverse’s home was scheduled at $223,500, which no one challenged. She listed the first mortgage of $185,777.30 as unsecured, since she knew it was unrecorded and therefore avoidable, and a perfected second mortgage of $29,431.04. She also claimed the maximum dollar value available under the Massachusetts homestead exemption ($500,000) as exempt. The arithmetic is clear: Adding the second, unavoidable mortgage

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1 Aside from Traverse, the author represented the petitioner in Marrama v. Citizens Bank of Massachusetts, et al., 127 S. Ct. 1105 (2007), among other published decisions.


4 With one minor quibble. In footnote 4, the court said that “a debtor who remains current on her loan payments must also enter into a valid reaffirmation agreement in order to prevent a mortgagee from foreclosing.” This is an incorrect statement of law and conflicts with the First Circuit’s own decision in In re Jams, 283 F.3d 392 (1st Cir. 2002), in which the court held that reaffirmation requires a contractually binding “meeting of the minds” (i.e., the mortgagee must agree, contractually, to reaffirmation, which would not necessarily be the original terms). Absent reaffirmation, the mortgagee is left to exercise its contractual rights, which, as Traverse-recognized, cannot be exercised as a matter of state law in the absence of a default under the promissory note. Furthermore, Massachusetts law requires that the mortgagee also be the holder of the note at the time of foreclosure. Eaton v. FNMA, 462 Mass. 569 (2012). Since the trustee is not the holder of the note, he could not foreclose even if Traverse were in default, and conversely, neither could the holder of the note since it is not the mortgagee. The circuit denied Traverse’s petition for rehearing on that point, stating essentially that the footnote was dicta.


7 Not unlike Law v. Siegel, 134 S. Ct. 1188 (2014), which dramatically cabined the equitable powers of bankruptcy judges, limiting them to usage only when doing so does not contravene the express statutory provisions of the Bankruptcy Code.


11 Debtor’s counsel often claim as exempt only the value of the property above other interests in the property, even if the statutory amount of the exemption could be higher. For example, the Massachusetts homestead exemption is $500,000, but if the equity above the mortgage is estimated at only $100,000, only $100,000 would be claimed as exempt. One bankruptcy judge (who has since retired) has expressed bewilderment at that thinking, the reason for which is precisely what caused problems for the debtor in Schwab.
to the exemption, there was no equity in the property for a trustee to administer. Viewed this way, the Traverse court recognized that if the trustee sold Traverse’s home, the only entities that would get paid would be the second mortgagee and Traverse (and conceivably, a real estate broker). The trustee, arguably would not be paid unless he could make a deal with the second mortgagee, since Traverse’s exempt interest had been withdrawn from the estate and, as Law v. Siegel makes clear, exempt property cannot be touched by the trustee or any other entity, except in very limited circumstances. General unsecured creditors (including the unperfected first mortgagee) would get nothing.

Ford was correct in his article that there is nothing in § 363 that overcomes this problem, but for another reason as well. Once the debtor’s interest in the property has been exempted, and thus withdrawn from the estate, the trustee cannot sell that interest. The result is that the trustee cannot convey a good and clear title to anyone who would purchase the property; the trustee could only convey the mortgagee’s interest in the property, which he avoided and thereby “stepped into the shoes” of the mortgagee. Realistically, the only entity that probably would want to buy that interest is the (former) mortgagee, or possibly the title insurance company.

The question then becomes: What is the value of the mortgagee’s interest? The trustee cannot reform the mortgage in order to perfect it. It is not necessarily the value of the payments remaining under the promissory note, nor is the trustee entitled to receive those payments.

There is no easy answer to that question (i.e., the value of that interest), since the First Circuit left it unanswered. As the foregoing shows, however, the First Circuit got it right on the law; now the bankruptcy courts must grapple with the “head-scratching” factual question of valuation.

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15 Id. (both citing Traverse, fn.9).