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G. Stanley Joslin

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## REAL PROPERTY IN BANKRUPTCY: SOME SPECIAL CONSIDERATIONS

G. STANLEY JOSLIN\*

All property of a bankrupt, except exempt property, passes into the bankrupt's estate.<sup>1</sup> However, there are provisions in the Bankruptcy Act which single out real property for special and sometimes unique treatment.<sup>2</sup> Many of these special and unique treatments are not obvious and may be overlooked, especially in the pre-bankruptcy period, with surprising and disastrous results to either the bankrupt or his creditors.<sup>3</sup> The basic concern here is the general Bankruptcy Act,<sup>4</sup> but reference will also be made to real estate involvements under Chapter X (Corporate Reorganizations)<sup>5</sup> and Chapter XI (Arrangements)<sup>6</sup> of the Act. No consideration will be given to Chapter XII (Real Property Arrangements By Persons Other Than Corporations)<sup>7</sup> and little to Chapter XIII (Wage Earners' Plans)<sup>8</sup> of the Act.

### *Real Property Passes to the Trustee*

A provision in the Bankruptcy Act states that the trustee of the estate of the Bankrupt, upon his appointment, is vested with the title to all property of the kinds thereunder designated.<sup>9</sup> These designations include almost every conceivable type of property<sup>10</sup> yet special reference is made to specific real property interests,<sup>11</sup> seemingly to reiterate and emphasize that these particular interests in real property do pass to the trustee. Thus, it will be noticed that Section 70(a) (7) of the Act specifies that the trustee is vested with title to:

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\*Candler Professor of Law, Emory University; Member of the United States Supreme Court's Bankruptcy Rules Advisory Committee. B.A., 1934 Cornell College; LL.B., 1939, J.D., 1968 Wisconsin University; LL.M., 1952 Michigan University.

<sup>1</sup>Bankruptcy Act § 70(a), 11 U.S.C. § 110(a) (1964).

<sup>2</sup>E.g., Bankruptcy Act § 60(a) (2), 11 U.S.C. § 96(a) (2) (1964).

<sup>3</sup>E.g., Bankruptcy Act § 63(a) (9), 11 U.S.C. § 103(a) (9) (1964).

<sup>4</sup>Bankruptcy Act §§ 1-72, 11 U.S.C. §§ 1-112 (1964) (commonly referred to as straight bankruptcy).

<sup>5</sup>Bankruptcy Act §§ 101-276, 11 U.S.C. §§ 501-676 (1964).

<sup>6</sup>Bankruptcy Act §§ 301-399, 11 U.S.C. §§ 701-799 (1964).

<sup>7</sup>Bankruptcy Act §§ 401-526, 11 U.S.C. §§ 801-926 (1964).

<sup>8</sup>Bankruptcy Act §§ 601-686, 11 U.S.C. §§ 1001-1086 (1964).

<sup>9</sup>Bankruptcy Act § 70(a), 11 U.S.C. § 110 (a) (1964).

<sup>10</sup>See Bankruptcy Act § 70(a) (5), 11 U.S.C. § 110(a) (5) (1964).

<sup>11</sup>E.g., Bankruptcy Act § 70(a) (7), 11 U.S.C. § 110(a) (7) (1964).

contingent remainders, executory devises and limitations, rights of entry for condition broken, rights or possibilities of reverter, and like interests in *real property*, which were nonassignable prior to bankruptcy and which, within six months thereafter, become assignable interests or estates or give rise to powers in the bankrupt to acquire assignable interests or estates . . .<sup>12</sup>

The usual provision for determining what property will pass to the trustee, *i.e.*, property which was transferable or subject to judicial levy prior to the petition,<sup>13</sup> is not applicable to these interests in real property. Rather, a test of assignability within six months after the petition is applied.<sup>14</sup> Prior to this section, contingent interests in real property passed to the trustee only if they were subject to execution or were capable of assignment at the time of the petition in bankruptcy.<sup>15</sup> This former section extends to creditors a right to these contingent interests, which would not pass to the trustee at the time of the petition, if they became assignable within six months after the petition.<sup>16</sup> The present provision brings into the bankrupt estate the interests in real property which would not be in a form to be taken at the time of the petition, but which do assume another defined form within six months after the petition.

Other instances in which real property is specially designated as property which passes to the trustee, although the reference is indirect in that it is by terms usually applied to real property, are contained in the unlettered paragraphs of section 70(a). These provide that property which vests in the bankrupt by devise or inheritance within six months after bankruptcy shall pass to the trustee,<sup>17</sup> and interests by the entirety which become transferable by the bankrupt within six months of the petition in bankruptcy also vest in the trustee.<sup>18</sup>

These provisions, then, are especially applicable to real property and provide for a determination of its character for purposes of ascertaining whether or not it will pass to the trustee at a time within six months of the bankruptcy rather than at the point of time of the petition which is the usual point of determination. They are sometimes called the "after-acquired" property provisions of the Act.

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<sup>12</sup>Bankruptcy Act § 70(a) (7), 11 U.S.C. § 110(a) (7) (1964) (emphasis added).

<sup>13</sup>Bankruptcy Act § 70(a) (5), 11 U.S.C. § 110(a) (5) (1964).

<sup>14</sup>Bankruptcy Act § 70(a) (7), 11 U.S.C. § 110(a) (7) (1964).

<sup>15</sup>Bankruptcy Act § 70(a) (7), 11 U.S.C. § 110(a) (7) (1964), *amending* Bankruptcy Act § 70(a), 11 U.S.C. § 110(a) (1938).

<sup>16</sup>*See* 4A W. COLLIER ON BANKRUPTCY ¶ 70.37 (14th ed. 1967).

<sup>17</sup>Bankruptcy Act § 70(a), 11 U.S.C. § 110(a) (1964) (First unlettered paragraph).

<sup>18</sup>Bankruptcy Act § 70(a), 11 U.S.C. § 110(a) (1964) (Second unlettered paragraph).

### Recording

A very important step which should be taken immediately upon the filing of a petition in bankruptcy is the recording of the proceeding to prevent real estate from being transferred by the bankrupt thereby making it unavailable to the bankrupt's estate.<sup>19</sup> This recording *may* be done by the receiver, referee, or any creditor<sup>20</sup> but *must* be done by the trustee as one of his assigned duties.<sup>21</sup> As it may be some time after the petition has been filed that a trustee is appointed, it would be wise for creditors to see that this recording is done at once.

The recording may be done by filing a certified copy of the petition, of the decree of adjudication, or of the order approving the trustee's bond in the office where conveyances of real property are recorded, in every county where the bankrupt owns such property and until so recorded there is no constructive notice except in the county where the record of the original bankruptcy proceeding is kept.<sup>22</sup> A conveyance made by the bankrupt after the petition, but before the required recording, does not affect the title of a subsequent bona fide purchaser who has paid a fair equivalent value without actual notice of the pendency of the bankruptcy proceeding.<sup>23</sup> However, one whose purchase is bona fide and without actual notice, but not for fair equivalent value, has a lien upon the property to the extent of the consideration actually given by him.<sup>24</sup> It should be re-emphasized that the recording of the original bankruptcy proceedings is constructive notice in regard to real estate in the county where the suit is brought so that no further recording is necessary in that county.<sup>25</sup> It should also be noted that real estate is expressly withdrawn from the good faith purchaser test provided for in personal property.<sup>26</sup>

It seems that no recording is necessary to protect real property received by the bankrupt by devise or inheritance within six months, as it is expressly provided that such property vests in the trustee as of the date when it vested in the bankrupt, and free from any transfer made by the bankrupt after bankruptcy.<sup>27</sup> As an added precaution,

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<sup>19</sup>Bankruptcy Act § 21(g), 11 U.S.C. § 44(g) (1964).

<sup>20</sup>*Id.*

<sup>21</sup>Bankruptcy Act § 47(c), 11 U.S.C. § 75 (c) (1964).

<sup>22</sup>Bankruptcy Act § 21(g), 11 U.S.C. § 44(g) (1964).

<sup>23</sup>*Id.*

<sup>24</sup>*Id.*

<sup>25</sup>*Id.*; see Bankruptcy Act, § 70(d) (5); 11 U.S.C. § 110(d) (5) (1964).

<sup>26</sup>Bankruptcy Act § 70(d) (1), 11 U.S.C. § 110(d) (1) (1964).

<sup>27</sup>Bankruptcy Act § 70(a), 11 U.S.C. § 110(a) (1964) (First unlettered paragraph).

however, it might be advisable for the trustee to record in the county where such real estate is located for further protection and to forestall some court from considering the equities which result from not recording.

### *Real Estate Leases*

Real estate leases may be involved in bankruptcy as an asset of the estate or as the basis for a claim against it. The trustee in straight bankruptcy has the right to either assume or reject unexpired leases of real property and is given a definite time within which to decide this matter.<sup>28</sup> If no decision is made within the prescribed time, the lease is deemed to be rejected<sup>29</sup> and the party not in default relegated to a claim in bankruptcy for the breach.<sup>30</sup> A judge under a Chapter X Corporate Reorganization may permit the rejection of unexpired leases of real property,<sup>31</sup> but until a decision is made the lease is deemed to continue subject to a later decision to assume or reject.<sup>32</sup> Moreover, the plan of reorganization itself may provide for the rejection of a lease if no formal assumption has been made.<sup>33</sup> This right to assume or reject real estate leases is also provided for in Arrangements under Chapter XI<sup>34</sup> of the Bankruptcy Act and in Wage Earners' Plans under Chapter XIII.<sup>35</sup> It should be kept in mind, however, that the lease itself may be made to terminate automatically upon bankruptcy.<sup>36</sup> The termination of a lease, unless of right, gives rise to a claim against the estate for its breach, while an assumption acquires an asset for the estate and, in all probability, some liabilities such as the contractual obligation for rent and other covenants.

Real estate leases are singled out for most unusual treatment in the bankruptcy process in regard to the rights of the lessor when a lease has been rejected. Although the full claim for breach of unexpired leases of real or personal property may be proved against the estate,<sup>37</sup> the claim arising from the breach may not be allowed in full.<sup>38</sup> In fact, in straight bankruptcy and in Chapter XIII Wage Earners'

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<sup>28</sup>Bankruptcy Act § 70(b), 11 U.S.C. § 110(b) (1964).

<sup>29</sup>Bankruptcy Act § 70(b), 11 U.S.C. § 110(b) (1964).

<sup>30</sup>Bankruptcy Act § 63(a) (9), 11 U.S.C. § 103 (a) (9) (1964).

<sup>31</sup>Bankruptcy Act §§ 106(7), 116(1), 11 U.S.C. §§ 506(7), 516(1) (1964).

<sup>32</sup>See 6 W. COLLIER ON BANKRUPTCY ¶ 3.23, at 576 (14th ed. 1965).

<sup>33</sup>Bankruptcy Act § 216(4), 11 U.S.C. § 616(4) (1964).

<sup>34</sup>Bankruptcy Act §§ 306(4), 357(2), 11 U.S.C. §§ 706(4), 757(2) (1964).

<sup>35</sup>Bankruptcy Act §§ 606(5), 613(1), 11 U.S.C. §§ 1006 (5), 1013 (1), (1964).

<sup>36</sup>See 3 H. REMINGTON ON BANKRUPTCY, § 1208 (1957).

<sup>37</sup>Bankruptcy Act § 63(a) (9), 11 U.S.C. § 103(a) (9) (1964).

<sup>38</sup>Bankruptcy Act § 63(a) (9), 11 U.S.C. § 103(a) (9) (1964) (First Proviso).

Plans, the claim of the landlord for damages for injury resulting from the rejection of an unexpired lease may in no event be allowed in an amount exceeding the rent reserved for the next succeeding year,<sup>39</sup> while the damages limit is more liberal in Chapter X Corporate Reorganizations<sup>40</sup> and Chapter XI Arrangements,<sup>41</sup> where the claim may be allowed to the amount of the rent reserved for the next succeeding three years. To one not conversant with bankruptcy practice, the full import of these rent claim limitations may be brought home by explaining that, although the full damage claim for the breach may be proved, it can only be allowed to the amount of one or three years rent as the case may be and the distribution is made on the basis of the allowed rent. Thus, if a twenty year lease for fifty thousand dollars rent a year, with fifteen years yet to run, is breached, resulting in damages of seven hundred and fifty thousand dollars, only fifty thousand dollars would be allowed where the one year limitation applied, and if, hypothetically, the distribution is five per cent of the allowed claims, the landlord would only receive two thousand five hundred dollars from the estate. Yet the entire claim would be discharged if a discharger were granted.<sup>42</sup>

The claim of a landlord which has been assigned is further subject to scrutiny and, after the circumstances of the assignment and the consideration paid therefore are determined by the court, the assignee's claim may be allowed in such amount as will be fair and equitable.<sup>43</sup> If a state law gives a priority to a landlord's claim for rent, the priority is restricted to the amount which accrued within three months before bankruptcy.<sup>44</sup> Liens of distress for rent are also postponed in payment to administrative expenses and wage claims.<sup>45</sup>

The rejection of a real estate lease by the trustee of the lessor does not, however, deprive the lessee of his estate in the property,<sup>46</sup> nor does a condition in a real estate lease that it shall not be assigned prevent the trustee from either assuming the lease or assigning it.<sup>47</sup>

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<sup>39</sup>Bankruptcy Act § 63(a) (9), 11 U.S.C. § 103(a) (9) (1964) (First Proviso); Bankruptcy Act § 642, 11 U.S.C. § 1042 (1964).

<sup>40</sup>Bankruptcy Act § 202, 11 U.S.C. § 602 (1964).

<sup>41</sup>Bankruptcy Act § 353, 11 U.S.C. § 753 (1964).

<sup>42</sup>Bankruptcy Act § 17(a), 11 U.S.C. § 35(a) (1964).

<sup>43</sup>Bankruptcy Act § 63(a) (9), 11 U.S.C. § 103(a) (9) (a) (1964) (Second Proviso); Bankruptcy Act § 202, 11 U.S.C. § 602 (1964); Bankruptcy Act § 353, 11 U.S.C. § 753 (1964); Bankruptcy Act § 642, 11 U.S.C. § 1042 (1964).

<sup>44</sup>Bankruptcy Act § 64(a) (5), 11 U.S.C.A. § 104(a) (5) (1964) (Supp. 1969).

<sup>45</sup>Bankruptcy Act § 67(c) (1), 11 U.S.C. § 107(c) (1) (1964).

<sup>46</sup>Bankruptcy Act § 70(b), 11 U.S.C. § 110(b) (1964).

<sup>47</sup>*Id.*

However, an express covenant that an assignment by operation of law or the bankruptcy of a party shall terminate the lease is effective.<sup>48</sup> If the lease is assumed and later assigned by the trustee to a third person, the trustee is not liable for breaches occurring after the assignment.<sup>49</sup>

### *Covenants in Warranty Deeds*

The relationship between a deed covenantor and covenantee in the bankruptcy of the covenantor, and the rights of these parties in the bankruptcy process, although quite clear to the bankruptcy lawyer, may be somewhat puzzling to another. In this regard, the covenant involved must be characterized as to its estimable nature, *i.e.*, whether the value of the claim for its breach can be reasonably estimated. Any covenant which has been breached at the time of the petition, such as the covenant of seisin,<sup>50</sup> is the basis for a provable claim against the grantor's bankrupt estate by the covenantee for the damages resulting from such breach,<sup>51</sup> but the more complicated situation arises when the grantee has covenant rights against the bankrupt grantor but no breach has yet occurred. For example, a covenant of quiet enjoyment is not breached until the grantee's possession and enjoyment are disturbed<sup>52</sup> and this may not have occurred at the time of the bankruptcy. The question, then, is whether the bankrupt covenantor is discharged of this liability by his bankruptcy or will he be liable after bankruptcy to a covenantee for a later breach. It does seem that such a claim may be characterized as a contingent claim and contingent claims are normally discharged in bankruptcy.<sup>53</sup> As provable claims are normally discharged in bankruptcy,<sup>54</sup> it appears at this point that any claim for such a later breach would be discharged by the grantor's bankruptcy, thus depriving the covenantee of any right on the covenant. However, a saving clause is provided in the Act which would prevent the discharge. It provides that any proved contingent claim which has been found not allowable because it was not capable of reasonable estimation, or that such liquidation or estimation would unduly delay the administration of

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<sup>48</sup>*Id.*

<sup>49</sup>*Id.*

<sup>50</sup>7 G. THOMPSON ON REAL PROPERTY, § 3180 (Repl. Vol. 1962).

<sup>51</sup>Bankruptcy Act § 63(a), 11 U.S.C. § 103(a) (1964).

<sup>52</sup>7 G. THOMPSON ON REAL PROPERTY, § 3192 (Repl. Vol. 1962).

<sup>53</sup>Bankruptcy Act § 63(a) (8), 11 U.S.C. § 103(a) (8) (1964).

<sup>54</sup>Bankruptcy Act § 17(a), 11 U.S.C. § 35(a) (1964).

the estate, shall not be deemed "provable."<sup>55</sup> This, then, removes such a claim from being discharged as only provable claims are discharged.<sup>56</sup> This is one of the "Merry-Go-Rounds" in bankruptcy: Provable claims are discharged under section 17a. Contingent claims are provable under section 63(a) (8), but if these are too contingent they are not allowable under section 57(d). If not so allowable, they aren't provable under section 63(d) and, therefore, are not discharged under section 17(a). Covenants of warranty in deeds which are the basis for contingent liabilities, then, are not affected by the bankruptcy and discharge of the covenantor. Only covenants breached that give rise to claims reasonably capable of evaluation within a reasonable time are affected by it, or, putting it as a general rule—covenants in warranty deeds are not affected by the bankruptcy of the covenantor where there has been no breach of the covenant at the time.

### *The Time of Transfer*

One of the most important problems in bankruptcy is the determination of the exact time when a transfer was made. This is especially critical in determining whether preferences have occurred<sup>57</sup> or fraudulent conveyances perpetrated.<sup>58</sup> In most cases, the time of transfer is determined by a formula equally applicable to real and personal property, but in certain instances the time computation for a transfer of real property is determined by a unique, special formula applicable only to real estate.<sup>59</sup> In determining when a transfer of real estate has been made to determine whether the transfer of real estate was a voidable preference, the transfer is deemed to have been made when it became so far perfected that no subsequent bona fide purchaser from the bankrupt could create rights in it superior to the rights of the transferee.<sup>60</sup> This test for determining the time of transfers of real estate is called the "bona fide purchaser test for perfection" as distinct from the judicial lien test to which transfers of personal property are subjected.<sup>61</sup> The judicial lien test is an abbreviated way of saying that the transfer is so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings

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<sup>55</sup>Bankruptcy Act § 63(d), 11 U.S.C. § 103(d) (1964).

<sup>56</sup>Bankruptcy Act § 17(a), 11 U.S.C. § 35(a) (1964).

<sup>57</sup>Bankruptcy Act § 60(a), 11 U.S.C. § 96(a) (1964).

<sup>58</sup>Bankruptcy Act § 67(c) (2), (3), 11 U.S.C. § 107(d) (2), (3) (1964).

<sup>59</sup>Bankruptcy Act § 60(a) (2), 11 U.S.C. § 96(a) (2) (1964).

<sup>60</sup>*Id.*

<sup>61</sup>*Id.*

could become superior to the rights of the transferee.<sup>62</sup> Thus, a transfer of real estate perfected insofar as creditors are concerned, still would not be timed as a transfer for preference purposes until the transfer became perfected against a bona fide purchaser.

### *Incidentals*

A brief reference should also be made to less important special involvements of real estate in bankruptcy. Thus, it should be noted that vested interests of a bankrupt's spouse in real estate may be liquidated if the applicable state law empowers creditors to compel such spouse to accept a money satisfaction for such interest.<sup>63</sup>

Where real estate is sold by the court in a judicial sale, the actual conveyance of title is made to the purchaser by the trustee in bankruptcy.<sup>64</sup>

A recent amendment to the Act also provides that rent owing to a landlord who is entitled to a priority by state law or who is entitled to a priority under section 67(c) (2) of the Act, is entitled to an additional priority in bankruptcy. This is limited, however, to a priority for rent for actual use and occupancy of the premises affected and further restricted to rent which accrued within three months before the bankruptcy.<sup>65</sup> Another recent amendment provides that statutory liens for rent and every lien of distress for rent is invalid against the trustee,<sup>66</sup> but may be preserved for the benefit of the estate.<sup>67</sup> Such invalidated rent liens, however, leave allowable rent claims which are entitled to priority granted them by section 64.<sup>68</sup>

It should also be noted that claims in a Chapter XIII Wage Earners' Plan do not include claims secured by real estate or chattels real.<sup>69</sup>

### *Summary*

Real property, it has been seen, receives special treatment in many aspects of bankruptcy: it is especially subjected to the after acquired provisions of section 70 of the Bankruptcy Act; it has specific record-

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<sup>62</sup>*Id.*

<sup>63</sup>Bankruptcy Act § 2(a) (7), 11 U.S.C. § 11(a) (7) (1964).

<sup>64</sup>Bankruptcy Act § 70(g), 11 U.S.C. § 110(g) (1964).

<sup>65</sup>Bankruptcy Act § 64(a) (5), 11 U.S.C.A. § 104(a) (5) (Supp. 1969).

<sup>66</sup>Bankruptcy Act § 67(c) (1) (C), 11 U.S.C.A. § 107(c) (1) (c) (Supp. 1969).

<sup>67</sup>Bankruptcy Act § 67(c) (2), 11 U.S.C.A. § 107(c) (2) (Supp. 1969).

<sup>68</sup>Bankruptcy Act §§ 64(a) (2) (4) (5), 67(c) (2), 11 U.S.C.A. §§ 104(a) (2) (4) (5), 107(c) (2) (Supp. 1969).

<sup>69</sup>Bankruptcy Act § 606(1), 11 U.S.C. § 1006(1) (1964).

ing requirements; real estate leases have a very unique and, perhaps a disquieting treatment under bankruptcy; contingent claims arising on warranty deeds may have a circuitous path; and the time of transfer of real estate has its special treatment. Most of these facets of real estate involvement in bankruptcy are important to the nonbankruptcy attorney and essential to the bankruptcy lawyer—the first as a preventative and the second as a professional necessity.