Unscheduled Debtor Assets: A Risk to Purchasers in Good Faith?

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Last year, a California bankruptcy court held that a debtor's failure to schedule real property as an estate asset decades earlier justified reopening the case to administer estate property. This decision provoked considerable discussion in the bankruptcy bar, and may cause concern on the part of property owners that a past owner's long-ago omission on bankruptcy schedules could affect title into the present day. However, a number of bankruptcy and other doctrines could help clear potential clouds on title where a former debtor-owner failed to schedule estate property.

In re Dunning Brothers Co.

In the 2009 case of *In re Dunning Brothers Co.*, 410 B.R. 877 (Bankr. E.D. Cal. 2009), the Bankruptcy Court for the Eastern District of California was faced with an unusual request. It was asked to reopen a bankruptcy case that had been closed 73 years earlier to clear title to three parcels of land that the debtor failed to list as assets on its bankruptcy schedules.

In *Dunning Brothers*, the debtor had filed a voluntary petition in bankruptcy in 1936, under the long-superseded Bankruptcy Act of 1898. The debtor owned three parcels of land burdened with a railway right-of-way. It failed to schedule the assets, and as a result the parcels were not administered in the bankruptcy case. 410 B.R. at 880.

Over seven decades later, the railway owner was seeking to acquire outright ownership of the property under its tracks. It determined that title to the three parcels in question was clouded. In order to clear title, it purchased the interest of a creditor of the bankruptcy estate to give itself standing, and then sought to reopen the case so it could acquire clear title to the property. The court reopened the case to administer the parcels as estate property.

The *Dunning Brothers* court's analysis illustrates the "potency" of the doctrine that, upon filing a bankruptcy petition, a debtor's property becomes vested in the bankruptcy estate. *Id*. at 879;11 U.S.C. § 541. *Dunning Brothers* explained that "cause" to reopen a case exists where there are estate assets in need of administration. The three parcels constituted property of the estate because, under "[l]ong-settled bankruptcy law," property "that is not

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scheduled does not lose its character as property of the estate after the case is closed." *Id*. at 888. Moreover, "title to unscheduled property does not revert to the debtor upon the closing of the case." *Id*. Thus, although the Dunning Brothers' bankruptcy case had been closed for decades, the court found "cause" to reopen the case and enable the administration of estate assets (the parcels of land) that had not been scheduled by the debtor.

Because the parcels at issue in *Dunning Brothers* had not been transferred after the bankruptcy filing, the court did not need to determine the rights of an intervening good faith purchaser. In *dicta*, however, the court said the burden should be on the party seeking to "overcome[e] the rights of the estate," rather than on the estate itself. *Id*. at 889. A good-faith purchaser seeking to clear title to property which a former debtor-owner failed to schedule could make several arguments to carry that burden. Some of those argument are discussed below.

Retroactive Annulment of the Automatic Stay

Section 362(a)(1) of the Bankruptcy Code "provides that the filing of a bankruptcy petition automatically stays all post-petition acts against a debtor and property of the debtor's estate, subject to limited exceptions." *In re Bright*, 338 B.R. 530, 534 (1st Cir. BAP 2006). While the automatic stay is in place, sales of estate property by persons other than the debtor "are void and without legal effect." *Bright*, 338 B.R. at 535. This applies even to purchasers in good faith, who lack knowledge that the property belongs to a bankruptcy estate. *See, e.g., In re Mitchell*, 279 B.R. 839 (9th Cir. BAP 2002) (sale to good faith purchaser violated automatic stay).

A debtor's failure to schedule estate property could affect title where it is later acquired by a third party in violation of the automatic stay. For example, a current owner may become aware that, years earlier, a predecessor-in-title obtained estate property in violation of the automatic stay (*e.g.*, through foreclosure).[3] In theory, the debtor's bankruptcy case could (as in *Dunning Brothers*) be reopened even decades later for administration of the asset as estate property. Once the case is reopened, the initial sale in violation of the automatic stay could be deemed "void" by the bankruptcy court, which would call into question the validity of all subsequent transfers of the estate property.

In that situation, it may be possible to resolve title issues through retroactive annulment of the automatic stay. Although no express statutory exception protects good-faith purchasers of estate property from operation of the automatic stay, caselaw has established courts' power to validate a transfer in violation of the automatic stay through its retroactive annulment. Retroactive annulment is available "when equitable considerations warrant, to validate actions which otherwise would be void." *Bright*, 338 B.R. at 535.

[3] Section 362 "does not prohibit a *debtor* from disposing of property belonging to the bankruptcy estate ...." *In the matter of Cueva*, 371 F.3d 232, 236 (5th Cir. 2004) (emphasis supplied). Thus, the automatic stay would not be violated where the debtor itself transfers property.

In *Bright*, the debtor filed a bankruptcy petition but did not disclose her ownership interest of certain real estate on her schedule of assets. After the filing of the petition, one of the debtor's creditors, without knowledge of the pending bankruptcy, sold the property at auction to an unrelated third party. The creditor filed an interpleader action in state court to determine the ownership of surplus sale proceeds resulting from the sale of the estate property. Then, long after the debtor's bankruptcy case had been closed, the debtor alleged the creditor violated the automatic stay by selling property in which she had an ownership interest.

The creditor obtained an order reopening the bankruptcy case and filed a motion to retroactively annul the automatic stay. The motion was granted by the bankruptcy court and upheld on appeal. In upholding the ruling, the Bankruptcy Appellate Panel for the United States First Circuit discussed retroactive annulment at length. The court noted that while the doctrine should be used only in "extreme circumstances," it is properly applied when the facts of a case are "both 'unusual' and 'unusually compelling.'" 338 B.R. at 535. Examples include "(1) where a creditor inadvertently violated the automatic stay because it lacked knowledge of the bankruptcy, or (2) where a debtor acted in bad faith," both of which were true in *Bright*. *Id*. The court also noted that it is appropriate to consider the rights of intervening, innocent purchasers of the property. *Id*. at 537. The court recognized that, absent annulment, "subsequent purchasers would be detrimentally affected, and their intervening rights weigh in favor of granting retroactive relief from the automatic stay." *Id*. at 537-38.

Other courts have likewise used retroactive annulment of the automatic stay to protect the interests of good faith purchasers. For example, in *In re Howard*, 391 B.R. 511 (Bankr. N.D. Ga. 2008), the court retroactively validated a sale of estate property that was made in violation of the automatic stay. The sale was made by an unlisted creditor, without notice of the bankruptcy case, to a non-party who purchased the property in good faith. The court's decision to annul the automatic stay retroactively hinged on an analysis of a variety of factors, including specifically the innocence of the non-party purchaser. *Howard* supports retroactive validation of a sale of estate property to a purchaser in good faith. *See also, In re Nat'l Envtl. Waste Corp.*, 120 F.3d 1052 (9th Cir. 1997) (retroactively annulling automatic stay and validating termination of contract due to "unusual circumstances").

Thus, retroactive annulment of the automatic stay is one avenue that may be available to good-faith purchasers whose immediate and/or earlier predecessors-in-interest may have held questionable title due to an earlier violation of the automatic stay.

Defending an Avoidance Action

While the automatic stay prevents *creditors* from taking action with respect to estate property, it does not prohibit the *debtor* from transferring estate property. *In re Tippett*, 542 F.3d 684, 691-92 (9th Cir. 2007); *In re Cueva*, 371 F.3d 232, 236 (5th Cir. 2004). While not "void" under § 362, however, a sale of estate property by a debtor is subject to avoidance by a bankruptcy trustee under 11 U.S.C. § 549. That section authorizes a trustee to avoid (invalidate) certain postpetition transactions involving estate property. This power could be invoked as to a good-faith transferee who acquires unscheduled estate property from a debtor.

Where a good-faith purchaser is faced with an avoidance action, two key defenses may apply. The first is set forth in § 549(d), which states that an avoidance action "may not be commenced after the earlier of" either (a) two years after the date of the transfer sought to be avoided; or (b) the time the bankruptcy case is closed or dismissed. By placing a strict time limit on actions to avoid postpetition transfers of estate property, § 549(d) ensures a trustee will not be able to challenge a sale of estate property after, at most, two years have passed. By way of example, if the debtor in *Dunning Brothers* had sold the unscheduled property to the railroad postpetition, it would be too late for the trustee to avoid the sale following the reopening of the case decades later.

Another defense to an avoidance action is set forth in § 549(c). The purpose of that provision is to "protect against a fraudulent debtor selling real property, or its interest therein, for present fair equivalent value to an innocent purchaser who has no knowledge, or reasonable means of knowledge, of the pendency of the bankruptcy case." 5 COLLIER ON BANKRUPTCY ¶549.06 (15th ed. rev.). Generally, absent timely filing of notice of the bankruptcy in the public records, § 549(c) prevents a trustee from avoiding a transfer of real property if the purchaser (a) did not have knowledge of the bankruptcy; and (b) paid "present fair equivalent value" for the property. Thus, as long as a good faith purchaser gave fair market value for estate property sold by the debtor, its interest in the property may survive a timely avoidance action by the trustee.

Adverse Possession

A good-faith purchaser could also argue that, under state law, it has acquired title to estate property by adverse possession. However, the validity of that argument is uncertain. No caselaw could be found which addresses whether adverse possession can run against estate property subject to the automatic stay. The language of the automatic stay provision, however, suggests adverse possession cannot run against estate property. Section 362(a)(3) provides that the filing of a bankruptcy petition operates as a stay of "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." This arguably encompasses (and stays) adverse possession.[4] Moreover, under § 362(c)(1), the stay operates as to estate property until it is "no longer property of the estate," and thus continues after the bankruptcy case is closed. *See, e.g., Dunning Brothers*, 410 B.R. at 889 (noting that

[4] In *General Iron Industries, Inc. v. A. Finkl and Sons Co.*, 686 N.E. 2d 1 (Ill. App. Ct. 1997), the court held that the filing of a bankruptcy petition interrupts the period of continuous possession required for adverse possession. However, the court expressly declined to decide whether a new period of adverse possession would begin to run upon the filing of the petition or upon the occurrence of later events in the bankruptcy. *Id*. at 5. A Civil War-era Supreme Court case suggests that, under a long-superseded predecessor to the Bankruptcy Code, the trustee (or "assignee" under the old parlance) must bring a claim against a postpetition adverse possessor within two years of when the possession begins. *Banks v. Ogden*, 69 U.S. 57, 17 L.Ed. 818, 2 Wall. 57 (1864). Whether a similar limitation would be applied to a trustee under the current Bankruptcy Code, which includes a two-year statute of for avoidance actions in § 549(d), is speculative.

automatic stay continues after bankruptcy case is closed). Given the dearth of clear authority on this issue, however, an argument based on adverse possession could nonetheless be made.

Conclusion

Dunning Brothers indicates that a bankruptcy case may be reopened even decades later to administer unscheduled assets as estate property. There, the case was reopened at the request of a party seeking to obtain clear title to property, rather than one claiming an interest in the property. It is possible that parties claiming an interest in property could seek to reopen long-closed bankruptcy cases and thereby cast doubt upon the current owner's title. This does not, however, necessarily mean that anyone who owns property that may have, in the distant past, constituted unscheduled property of a bankruptcy estate has an insoluble title issue on its hands. The doctrines of retroactive annulment of the automatic stay, the statute of limitations on avoidance actions, the good-faith purchaser defense, and the doctrine of adverse possession may be available to clear title in that situation.