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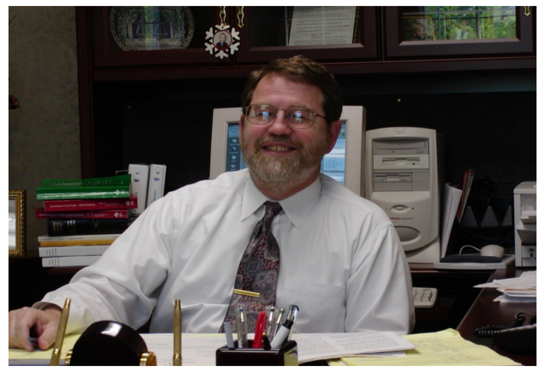
Of Bankruptcy and Real Estate

from the desk of David M. Touchstone

Most lawyers who deal much with real estate are specialists. Most lawyers who deal with bankruptcy are specialists. Generally, those two worlds are not only separate planets, but also pretty dang far from each other. Every now and then the two worlds collide, and the lawyers from each of the worlds find themselves struggling to understand interplanetary languages. So, if you have worked a deal involving a bankruptcy issue and found yourself lost at sea, don't feel alone.

Maybe I can help a little.



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Let's start at the beginning. Just what is a bankruptcy? The concept of bankruptcy is deeply rooted in our history and culture. During the Roman Empire, emperors newly ascendant to the throne often commenced their reigns by issuing edicts releasing debtors from all or a fraction of their debts. Maybe the emperors did this to curry favor with the masses; maybe their motives were more high minded. Maybe they wished to alleviate the social pressures that were building up from disproportionately allocated wealth. Whatever the reason, over time, debt relief was formalized into the law. From the very beginning, Louisiana included provisions in the Louisiana Civil Code that granted relief to debtors. Our system was essentially supplanted in 1898 when the U. S. Congress created the first national system of bankruptcy law. This first system was pretty straightforward. Generally speaking, this was the way it worked: (a) debtor declared bankruptcy by filing a petition in bankruptcy, (b) a trustee in bankruptcy was appointed by the court, (c) debtor gave all his stuff of every kind whatsoever to the bankruptcy trustee, (d) trustee sold the stuff for whatever he could get for it (e) trustee distributed the money from the sale to the debtor's creditors ratably according to the size of the debts each of them held, and (f) creditors could no longer pursue their claims against the debtor. Thus, the debtor achieved a "fresh start" by the filing of bankruptcy.

Over time, this system evolved. One of the areas distinguishing modern bankruptcy law from the original system is the area of exemptions. As time has gone along, Congress has added more and more exemptions, meaning that debtors can keep certain kinds of property even though they file bankruptcy. We'll revisit this point later in the article.

You may have heard someone refer to a bankruptcy as a "Chapter 7 bankruptcy" or a "Chapter 13 bankruptcy" without knowing why it was called by that name. Whenever the U.S. Congress passes a new law or amends an old one, it has to go into the United States Code somewhere; the U.S. Code is a compilation of all of the laws passed by the Congress. There are 50 "titles" in the U.S. Code. One of these is Title 11, which is the title in which all (or nearly all) of the laws pertaining to bankruptcy are found. Predictably enough, Title 11 is divided into "chapters." Some of the chapters address issues that are common to the various types of bankruptcy while other chapters address specific types of bankruptcy and the issues that arise with respect to those different types of bankruptcy. While there are some other, more exotic forms of bankruptcy, the types that are routinely filed are Chapter 7, Chapter 11, Chapter 12, and Chapter 13. Chapter 11 and Chapter 12 bankruptcy are both reorganization types; Chapter 11 is a business reorganization bankruptcy while Chapter 12 is a farmer reorganization bankruptcy. I am not going to spend more time talking about these, because they don't come up very frequently in the everyday business of being a real estate agent. On the other hand, Chapter 7 and Chapter 13 are more routine in what you and I do.

Chapter 7 bankruptcy is also sometimes referred to as "straight" bankruptcy. This is the traditional form of bankruptcy. At the moment a debtor files a Chapter 7 bankruptcy petition, he *no longer owns* any of his property (except that portion of his property which is exempt). Who does? The person appointed by the Bankruptcy Judge as the Trustee for the debtor's case succeeds to the title (ownership) of the debtor's property. After a Trustee is appointed, he will proceed to inventory the assets of the debtor to ascertain whether the debtor owns anything of value. If there are some nonexempt assets having value, the Trustee will sell them to raise money to pay to the debtor's unsecured creditors (those without a mortgage or lien on something). Please take note that in the previous sentence I used the expression "assets having value." By this phrase, I am referring to either unencumbered assets or not fully encumbered assets. If a house is worth $100,000, but has a $125,000 mortgage on it, as far as the Trustee is concerned, it has no value. The Trustee is not allowed to disregard a properly created and properly filed mortgage. In such an instance, the Trustee will simply walk away from the property. It has no equity; therefore, it has no value for the benefit of the debtor's unsecured creditors.

But what if the house has no mortgage on it? In such a case, the Trustee will market the house, sell it, and distribute the nonexempt portion of the funds to the debtor's unsecured creditors. In real life, though, we seldom see a situation in which a person with no mortgage on his house chooses to file bankruptcy. Every now and then we see a situation in which property is not fully mortgaged. Suppose the debtor has a house that is his personal home which is worth $100,000, but which has a mortgage against it having a $50,000 payoff. In such a case, the Trustee will sell the house, pay $50,000 to the mortgage holder to pay off his mortgage, pay $25,000 to the debtor, and distribute the other $25,000 to the debtor's unsecured creditors. Now, you might be wondering why I said that the debtor gets $25,000. Remember that I said the house is the "personal home" of the debtor; in Louisiana, a homeowner has a $25,000 "homestead exemption." This homestead exemption is completely different from the homestead exemption that we all deal with on a daily basis when calculating the property tax burden. Louisiana offers two types of homestead exemptions: the $75,000 ad valorem tax exemption and the $25,000 tax exemption against seizure of one's home.

Sometimes Trustee sales present themselves in other factual scenarios. For instance, we recently had a closing in which the debtor who had filed a Chapter 7 case owned a 100-acre tract. Although there was a mortgage against the entire tract, the Trustee in our deal was selling only 3 of the acres. In this case, the Trustee caused the property to be valued, obtained a court order authorizing the sale, and after sale turned over all the proceeds from the sale to the mortgage holder. I presume the Trustee believed that there was enough value in the 100-acre tract that if he broke out tracts and sold enough of them, eventually he would retire the entire mortgage indebtedness, thus realizing a payout to the unsecured creditors.

In all of the scenarios I laid out in the above paragraph, the Trustee has to seek and obtain approval of the Bankruptcy Judge. Now, this is something to which your ears should perk. Court approval takes time. The bankruptcy procedural rules require that the Trustee mail notice to all of the debtor's creditors (and other persons in interest). The persons who are entitled to notice must receive that notice at least 20 days prior to the date of the Court's hearing on the Trustee's proposal to sell the debtor's property. Furthermore, others are entitled to either object to the proposed sale (which seldom happens) or make a higher bid for the property (which sometimes does happen). The sale cannot go forward until the Bankruptcy Judge has signed an order authorizing it. We title lawyers are very sensitive to the content of the filing by the Trustee. If you are handling a deal in which a Trustee is about to seek court approval of a proposed sale, PUHLEEZE let us look at it BEFORE the Trustee files his motion. Trustees routinely screw up the proposed deed in various ways, fail to include language in the motion and order requiring the parish clerk of court to release liens from the property, and fail to clearly provide guidance as to how we closing agents are to distribute the funds generated at closing. If the Trustee goofs any of this up, then the motion will have to be filed anew, resulting in additional delay and the possibility that someone will come to the second hearing and outbid the buyer in your deal.

Frequently, Chapter 7 Trustees just decide to do nothing with a heavily encumbered property. So, you might be wondering, how does this situation play out? Remember, at the moment a debtor files his Chapter 7 bankruptcy petition, he no longer owns the property; the Trustee owns it. This only ends when the Bankruptcy Judge signs an order "abandoning" the property from the bankruptcy estate or when the Trustee himself files an "abandonment." When the property is abandoned, title re-vests in the debtor and the debtor is free to deal with the property without seeking approval of the Bankruptcy Judge. Of course, the debtor may still have to deal with some gnarly mortgage holders. Oftentimes, these situations are ripe for a "short sell."

Let's spend a little time now talking about Chapter 13. You may have heard Chapter 13 referred to as "reorganization" bankruptcy, and if you are old enough, you may have heard it referred to as a "wage earner plan." Prior to 1979, only "wage earners" could file Chapter 13 bankruptcy; the idea was that the debtor's employer would deduct a court-ordered portion of the debtor's paycheck and send it to the Chapter 13 Trustee who would then make distribution to the debtor's creditors in accordance with an approved plan. In 1979, Chapter 13 was broadened to include persons who were not necessarily "wage earners" but were persons having regular and periodic income. Up until a few years ago, persons who were candidates for a bankruptcy filing and who otherwise qualified for Chapter 13 had their choice of filing Chapter 13 or Chapter 7. During the Bush administration, the credit card companies were successful in obtaining amendments to the bankruptcy laws that require most debtors to file a 13 as opposed to a 7 and that make filing a bankruptcy more difficult.

Well, just what is a Chapter 13 bankruptcy? In a Chapter 13 bankruptcy, the debtor files a "plan." In the plan, the debtor proposes to repay all or a portion of the debts over time, frequently 36 months. The debtor can't just put anything he wants in the plan; there are rules as to how the plan is to be structured (which I will not go into here because it is beyond the scope of this article). The debtor has to achieve court approval of his plan, which means that the Bankruptcy Judge signs a "Confirmation Order." Once the plan is confirmed, the debtor is obligated to do what he said he would do in the plan. Sometimes this may consist of making payments directly to a mortgage holder; sometimes it may consist of making payments to the Chapter 13 Trustee (for further distribution by him), and sometimes the plan includes both. One of the big differences between a Chapter 7 and a Chapter 13 is that in a 13, the debtor is "in possession." In other words, a debtor in a Chapter 13 retains physical possession of all the property that he owns at the time he files his petition, and his confirmed plan states that he will continue to possess. When a Chapter 13 debtor completes repayment of his plan, title to all of his property that he retained per the confirmed plan re-vests in him. In such an instance, for our purposes, it will be as though the debtor never filed a bankruptcy.

Let me share a Chapter 13 scenario I have experienced many times. Debtor loses his job for a time, or goes through a marital breakdown, or has serious illness in the family. For whatever reason, he gets behind on his house payments and the mortgage holder initiates a foreclosure action. Just a little before the property is scheduled to go on the auction block at the sheriff sale, the debtor goes to a bankruptcy attorney who files a Chapter 13. The debtor proposes a legally permissible repayment plan calling for full repayment of the mortgage and obtains confirmation of the plan. When it comes time to make the payments as called for by the plan, the debtor is unable to follow through. He decides he must sell the property and lists the property with his agent. This is feasible and, generally speaking, desirable to the mortgage holder. What should you do in this instance? First, you need to make sure that the debtor's attorney is aware that you have taken a listing. Second, you should make adequate disclosure with MLS and on a buy/sell contract when you are successful in landing a buyer. Third, you should have the closing agent (us, hopefully) run title on the property in question to determine whether there are other title problems such as past due taxes, judgments, second mortgages, etc. All of this will have to be addressed in the motion filed by the bankruptcy attorney, and the closing agent will need to coordinate with the bankruptcy attorney to make sure that the motion and order are correctly filed. Fourth, you need to be aware that the same 20-day motion and notice delay I described above is applicable in this instance. Our office has successfully closed numerous transactions having the same facts presented in this paragraph, so it is possible if you are careful and well organized.

What happens if the debtor does not perform his bankruptcy obligations in good faith? Well, if he behaves badly enough, his case will be dismissed. In such an instance, it will be as though the debtor has not filed for bankruptcy, because he receives none of the benefits and protections of the bankruptcy law. Many times agents have told me that their sellers filed bankruptcies, which the agents believed afforded the homeowners relief from the gremlins du jour; but upon research, I determined that the bankruptcy case had been dismissed. The moral here is to have a careful interview with listing candidates.

We frequently work deals in which there are judgments or other general legal mortgages (such as IRS liens) filed against either the seller or buyer in the parish clerk of court's mortgage records. When we point this out subsequent to our title examination, we are often breezily brushed off with, "That's okay, the seller [or buyer, as the case may be] filed a bankruptcy." Well, my friends, that isn't the end of things – not by a long shot. First, we have to determine whether the debtor received a bankruptcy discharge; in order to obtain a discharge, the debtor must have completed everything required of him by bankruptcy law. In the case of a Chapter 13 filing, the debtor must complete repayment of the plan to receive a discharge. Whether a Chapter 7 or a Chapter 13, the discharge is an official Bankruptcy Court order that forever terminates creditors' rights as to certain actions they would otherwise be able to pursue against the debtor. After determining whether the debtor obtained a discharge, we must then determine whether the creditor holding the judgment was listed in the bankruptcy; if the creditor was not listed in the debtor's bankruptcy schedules, we have to treat the judgment as though the bankruptcy has no effect against it.

But wait, we're still not to the end. There are timing issues that can suck us into the black hole. We have to look at *when* the judgment was recorded, *when* the property was acquired, and *when* the bankruptcy was filed. If we are dealing with a judgment against a buyer, the timing issue is not a problem, because, obviously, the judgment debt will have been discharged prior to our buyer's acquisition. If the judgment was properly discharged, it will not attach to the property that the buyer is purchasing. Nevertheless, we will have some documentation requirements to demonstrate to the world that the judgment does not attach to the property that the buyer is purchasing.

Sellers are a different matter. We are often presented situations in which a seller got into financial trouble while he owned the home, was sued, had a judgment recorded against him in the mortgage records, had his wages garnished, and then filed bankruptcy. The bankruptcy will stop the garnishment, *but it will not strip the judgment from the home.* Another situation is this: seller has a judgment recorded against him and then acquires the property (perhaps by donation or by inheritance) after the judgment. After both recordation of the judgment and acquisition of the property by the debtor, he files bankruptcy. Again, in this second scenario, the bankruptcy will not strip the judgment from the property. A third fact presentation is this: the judgment is recorded first, the debtor files bankruptcy, properly scheduling the debt and receiving a discharge on it; and he thereafter acquires the property. In this third scenario, the judgment does not attach to the property, because the bankruptcy discharge prevents it from attaching. In this third scenario, even though the judgment does not attach, we will likely have some documentation requirements, so that, once again, we can demonstrate to the world that it does not attach.

Occasionally I have files in which a judgment attached to the property owned by the would-be seller who subsequently filed a bankruptcy. If the debtor received a discharge and if he properly listed the judgment holder in his bankruptcy schedules, he *may* have a remedy by which he can strip the judgment from the property. Louisiana law allows a homeowner to use his $25,000 homestead exemption to strip judgments after the debtor receives a bankruptcy discharge (if the debt was properly scheduled). Example: (a) at the time the bankruptcy petition is filed, home is valued at $100,000, (b) there is a mortgage against the home having an $80,000 balance, and (c) there is a $10,000 judgment attached to the home. In such a scenario, the debtor can file a lawsuit in the state court and can obtain a judgment from the court ordering cancellation of the judgment insofar as it attaches to the home. The rationale behind this is that the judgment intrudes into the equity cushion allowed to the homeowner in the form of the $25,000 homestead exemption. Lawsuits are expensive and time consuming, so this line of attack needs to be undertaken as early as possible. I have used this approach on several occasions to get judgment holders to voluntarily partially release their judgments (usually by offering them the amount of money I proposed to charge to file such a lawsuit).

Well, I'm about ready to get off the bankruptcy planet and get back to my nice little hobbit real estate planet where nobody sues anybody and everybody is nice to everybody. Until next time, "Au Revoir."