

3/2/2007 Preliminary Draft
(Supplemental memo will issue after meetings with bankruptcy judges)

To: Road Home Legal Services Partners

From: Mark Moreau

Re: Road Home Bankruptcy Issues

Date: March 2, 2007

Background

Hurricane Katrina/Rita homeowners may be eligible for Road Home grants. A “Road Home Covenant Compensation” grant is a grant from the United States of America under the HUD Community Development Block Grant Program known as the Road Home Program. The State of Louisiana, Division of Administration, Office of Community Development, administers the Road Home grants.

First American reports that some prospective Road Home grantees are in bankruptcy. Others may file for bankruptcy before their grant closing or thereafter. First American says that they need to know whether these clients have authority to sign the closing documents. Also, First American says that Road Home won’t give the funds to clients if the mortgagee or other creditors can seize the Road Home funds. We were also advised that there will be no state legislative fix in the 2007 session which would provide statutory protection for Road Home funds.¹

A Road Home grant must be used to rebuild the grantee’s home. Generally, it is a “grant” and does not have to be paid back to the United States or the State of Louisiana. However, under current law, a grantee must pay back “duplicative” SBA loans with Road Home funds.² The grant funds are paid to a disbursement agent who releases funds as the house is rebuilt. Also, any current year delinquent real estate taxes will be taken out of the Road Home grant at the closing. The grantee has no choice as to these payments.

Road Home grants cannot be used to pay the mortgage. It is expected that most mortgagees will subordinate their mortgages to the encumbrances that the Road Home program will require its grantees to sign. But, homeowners eligible for Road Home assistance, have the

¹ For many debtors, a legislative fix might not help since exemptions are determined on the date the bankruptcy is filed.

² In February 2007, legislation was introduced to change this requirement.

option of selling their homes to Road Home.

HUD requires Road Home grantees to sign a declaration of covenants running with the land. These covenants essentially prohibit the grantee from selling his home or any interest therein for at least 3 years, except as authorized by the covenants. An earlier sale can only be made to a transferee who agrees to abide by the covenants, which would effectively require the transferee to live in the home. The grantee must maintain homeowner insurance and flood insurance. Generally, a grantee has to repay a prorated amount of the grant if he violates the covenants prior to the expiration of the 3 year grant period. This penalty does not apply in the case of bankruptcy. But, it does apply for involuntary transfers through foreclosure. Covenant Agreement, ¶ 9.

Issues

1. Whether the bankrupt can sign the Road Home closing documents and, if not, First American will want court approval for signing said documents
2. How will the Road Home funds be treated in Ch. 7 and Ch. 13 bankruptcies
3. Whether the Road Home funds can be protected in a Ch. 7 or Ch. 13 bankruptcy from seizure and liquidation by the creditors or trustees

This memo will also address several Road Home bankruptcy issues not raised by First American.

Analysis

1. **Court approval for execution of Road Home mortgage or other closing documents?**

Duty to Disclose

A debtor has a continuing duty to inform the trustee of assets acquired after the filing of the bankruptcy petition. *Jethroe v. Omnova Solutions*, 412 F.3d 598, 600 (5th Cir. 2005); *In the Matter of Coastal Plains*, 179 F.3d 197, 208 (5th Cir. 1999).

Chapter 13 bankruptcy

A debtor's execution of Road Home closing documents does not impair any creditors' rights. Reconstruction of the debtor's house will enhance the mortgage and secured creditors' security interests.

11 U.S.C § 1327(b) states that once a Chapter 13 bankruptcy plan is confirmed, property

of the estate vests in the debtor unless the plan or order confirming the plan provides otherwise. 11 U.S.C. § 1306(b) provides that a Chapter 13 debtor is in possession of all property of the estate, which is defined by § 541 to include “all legal or equitable interests of the debtor in property as of the commencement of the case.” See *Cable v. Ivy Tech State College*, 200 F.3d 467 (7th Cir. 1999); *Looney v. Hyundai Motor Mfg.*, 330 F.Supp. 2d 1289 (M.D. Ala. 2004). However, 11 U.S.C. § 1306 (a)(1) provides that the bankruptcy estate continues in existence until the case is closed, dismissed or converted, and that all § 541 assets acquired by the debtor during this time are property of the estate.

The meaning of the “vesting” language in § 1327(b) is uncertain and controversial. The 5th Circuit has not ruled on this issue. See *Woodward v. Taco Bueno Restaurants, Inc.*, 2006 WL 3542693 (N.D. Tx., Dec. 8, 2006). At least 4 different approaches to the §§ 1327(b) and 1306 “vesting” issue have been adopted by the circuit courts of appeal: estate termination, estate preservation, and two versions of estate transformation. See *Barbosa v. Soloman*, 235 F.3d 31, 36-37 (1st Cir. 2000).

In the estate termination approach, all property of the estate becomes property of the debtor upon confirmation and ceases to be property of the estate. In the estate preservation approach, all property remains property of the estate after confirmation until discharge, dismissal or confirmation. In the estate transformation approach, only that property necessary for execution of the plan remains property of the estate. In the final approach, all property vests in the debtor, but the bankruptcy estate continues to be funded by the debtor’s regular income and post-confirmation assets. *Barbosa v. Soloman, supra* at 36-37.

Clearly, court approval should be required for execution of Road Home grants if the Ch. 13 plan has not been confirmed or the confirmation order expressly states that Road Home grants do not vest in the debtor. As discussed above, the law is unclear as to the rights of post-confirmation Ch. 13 debtors. Therefore, the best course of action may be file a test case on whether court approval for execution of the Road Home grant documents is required after confirmation of the Ch. 13 plan.³

For a sale to Road Home by a Ch. 13 debtor, a Rule 6007 notice is required. Presumably, a motion to approve the sale would be requested by the title company given the uncertainty of the law on whether a post-confirmation Ch. 13 debtor may sell without court approval.⁴

³ A Ch. 13 debtor remains in possession of assets acquired post-confirmation. *Looney, supra* at 1292; 11 U.S.C. §§ 1306(a)-(b); 1327(c). It would seem that no court approval for execution of Road Home closing documents should be required if the Ch. 13 debtor acquires the Road Home grant after confirmation of the plan.

⁴ A Chapter 13 debtor has substantially the same powers as the trustee in other chapters. *Cable, supra* at 472. Therefore, it would seem that a Ch. 13 debtor should be able to use, sell,

In a new Ch. 13 bankruptcy, an interest in a Road Home grant should be listed. Given the restrictive covenants, the issue becomes how to value this interest in the bankruptcy petition. Should a nominal value be given? For new Ch. 13 bankruptcies, it is theoretically possible (but unlikely) that a trustee could use the best interests of the creditors test (liquidation test) to argue that a debtor must pay more, i.e., what they would get in a Ch. 7 liquidation. The best interests of the creditors test is performed by reference to the assets the debtor had on the filing date of the bankruptcy.

Government disaster benefits have been held to be property of the estate if the following occurred before the bankruptcy was filed: (1) the disaster losses and (2) enactment of the disaster relief legislation. *Burgess v. Sikes*, 438 F.3d 493 (5th Cir. 2006); *see also In re Bracewell*, 454 F.3d 1234 (11th Cir. 2006). Fuel assistance grants to which debtor entitled on date of bankruptcy were held property of estate even though payable to the utility. *Morris v. Philadelphia, Elec. Co.*, 45 B.R. 350 (E.D. Pa. 1984). We preliminarily believe that the effective date of the “enabling legislation” will be HUD’s final approval of the Road Home program, which appears to be May 30, 2006.

The Road Home disaster benefits may be distinguishable from those involved in *Burgess* and *Morris*. Do the Road Home grants meet the threshold requirement of an “entitlement.” The Road Home disaster benefits are not directly payable to the grantee and are not “cash.” They may only be used to rebuild the grantee’s home and are restricted by covenants that require that he live there for 3 years and prohibit him from selling the home. In a bankruptcy, a trustee only steps into the shoes of the debtor. The trustee cannot have greater rights than the debtor.

Depending on the level of HUD Road Home supervision, the grants may be excluded from property of the estate. In *Westmoreland Human Opportunities, Inc. v. Walsh*, 246 F.3d 233 (3d Cir. 2001), the 3d Circuit held that a nonprofit’s interest in a HUD Supportive Housing Grant was not property of the estate within the meaning of § 541 because of HUD’s pervasive, strict and minute oversight of the grant relationship. Does the HUD Road Home’s oversight and control of the Road Home grants also deprive these grants of the status of “property of the estate.” Note that if the Road Home grants are not property of the estate, they may be subject to claims of post-confirmation creditors. *In re Rangel*, 233 B.R. 191 (Bankr. D. Mass. 1999). As a practical matter, most unsecured creditors do not pursue litigation in Ch. 13 bankruptcies.

A Road Home grant should not trigger 11 U.S.C. § 1328 since the debtor does not incur

lease or mortgage property of the estate as he did before the bankruptcy case and no court approval should be required. *See also*, 11 U.S.C. §§ 363 (b), 1327; *see e.g., In re Walker*, 20 B.R. 372 (Bankr. E.D. Va. 1982) (Ch. 13 debtor free to sell assets after confirmation of plan); *In re Rangel*, 233 B.R. 191 (Bankr. D. Mass 1999)(post-confirmation Ch. 13 debtor not required to file motion to employ broker to sell property). However, Bankruptcy Rule 6007 does require a debtor in possession to give the trustee and creditors notice of any proposed sale of the property.

debt by execution of the Road Home closing documents.

If you are handling a Ch. 13 bankruptcy, you could practice “preventive law” and remove any doubt as to whether court approval is required to sign Road Home documents by trying to put a provision in the order confirming the Ch. 13 plan which approves the debtor’s execution of the Road Home closing documents. *Cf. U.S. Dept. of Air Force v. Carolina Parachute Corp.*, 907 Fo.2d 1469 (4th Cir. 1990).

Chapter 7 Bankruptcy

In a Chapter 7 bankruptcy, the debtor relinquishes his authority over nonexempt assets to the trustee. *Looney, supra* at 1292. The home is often exempt. But, the Road Home funds may not be exempt.

If the property is abandoned by the trustee, ownership status reverts to the debtor. A debtor may request that the court order the trustee to abandon property. 11 U.S.C. § 554(b). Generally, a trustee will not take fully encumbered property. Most Ch. 7 bankruptcies are concluded within 100 days, and thus the debtor’s loss of authority over his property is generally short-lived in a Ch. 7 bankruptcy. Dismissal of the bankruptcy reverts property to the debtor as it existed prior to the bankruptcy. 11 U.S.C. § 349(b); *In re Nash*, 765 F.2d 1410 (9th Cir. 1985).

2. Protection of Road Home Grants from Seizure

Chapter 13 Bankruptcy

Apparently, Road Home funds are not exempt from seizure under state law.⁵ If the funds are successfully used to rebuild a homestead, they would become part of the homestead and protected under La. R.S. 20:1 to the extent that equity does not exceed \$25,000. It is not clear whether there is any federal law that would exempt these funds.

The possible lack of exempt status for Road Home grants should not be a problem for Ch. 13 debtors who make their plan payments. A creditor may not seize property as long as the plan payments are being made. At the completion of the plan, the creditors will not be able to seize the property for debts discharged through the plan. A hardship discharge might be an option for a debtor who can’t make his plan payments.

Also, it may be possible to construe the Road Home grant proceeds as proceeds of a secured debt. If so, court approval could be sought to incur more debt to repair the home and the

⁵ R.S. 46:111 creates an exemption for certain public assistance which is defined as money payments under Title 46. *See In re Collins*, 170 F.3d 51 (5th Cir. 1999). Note, however, insurance proceeds are exempt under Act 601 of 2006, eff. August 15, 2006.

debt is treated as secured.

The 5th Circuit recently held that a change in financial circumstances may warrant an upward or downward modification of the plan. *In re Meza*, 467 F.3d 874 (5th Cir. 2006). The 5th Circuit appeared to say that 11 U.S.C. § 1329 does not provide for any threshold requirement to modify a Ch. 13 plan. *Id.* Unlike the 5th Circuit, several circuits require a substantial change in the debtor's financial condition for increases in plan payments.⁶

A Road Home grant does not appear to be a real change in the debtor's financial circumstances. The grant does not enable the debtor to pay more to his unsecured creditors.

The trustee or unsecured creditors may seek to increase plan payments if the Road Home grants are treated as "disposable income" or "projected disposable income." Funds, including lump sum payments and exempt income can be "disposable income" if they are "income" and they are "not reasonably necessary for the maintenance or support of the debtor or his dependents." *See In re Freeman*, 86 F.3d 478 (6th Cir. 1996).

Does the mechanical and historical test for "disposable income" in the 2005 bankruptcy amendments provide protection to a Road Home grant recipient? Probably not, a recent Louisiana bankruptcy decision holds that a court must still consider anticipated income and expenses when confirming a plan. *In re Devilliers*, 2007 WL 92504 (Bankr. E.D. La. Jan. 9, 2007). Road Home requires that a grantee use the funds to rebuild his home. One should argue that rebuilding the family homestead with Road Home funds is necessary for the support of the debtor and his dependents.

Chapter 7 Bankruptcy

Can the trustee force the debtor to sell his home under the sale option of the Road Home program when the debtor wants to rebuild? Will a debtor need to convert a Ch. 7 to a Ch. 13 to save his home? Note, that in conversions, property of the estate is determined by reference to the original filing date, *In re Casey*, 963 F.3d 1347 (10th Cir. 1992), and that Ch. 13 has a more expansive definition of "property of the estate." *See* 11 U.S.C. § 1306(a) (In Ch. 13, estate includes property acquired after commencement of case, but before closing of Ch. 13 case or conversion to Ch. 7). Protection of Road Home funds may be an important factor in the decision to elect Ch. 13 or 7.

3. Payment of Real Estate Taxes with Road Home Funds

Road Home will allow (or require) current year delinquent real estate taxes to be paid with Road Home grant funds at the closing. If one of the co-owners is in a Ch. 13 or Ch. 7

⁶ *In re Murphy*, 474 F.3d 143, 149-50 (4th Cir. 2007); *In re Hoggle*, 12 F.3d 1008, 1011 (11th Cir. 1994); *In re Anderson*, 21 F.3d 355 (9th Cir. 1994).

bankruptcy, what must be done? The debtor should have previously disclosed this secured debt. Payment of the taxes may allow the debtor to reduce his plan payments to eliminate future payments to the tax authority.

4. Renunciation of Inheritance

A co-owner of heir property who plans to file bankruptcy may want to consider a renunciation of his inheritance. An heir has a right to renounce an inheritance. La. Civ. Code art. 947. Under current law, a renunciation accretes an intestate heir's rights to those persons who would have succeeded to them if the heir had predeceased the decedent. La. Civ. Code art. 964. The renouncing heir is deemed to have never received his inheritance. *See* La. Civ. Code art. 954, 947 (eff. July 1, 1999); *In re Brumfield*, 1998 WL 834999. (M.D. La. 1998).

Normally, an inheritance becomes property of the bankruptcy estate if the decedent dies within 180 days of the debtor filing a bankruptcy petition. 11 U.S.C. § 541(a)(5). Under current 5th Circuit law, an inheritance does not become part of the bankruptcy estate if the heir renounces before filing the bankruptcy. *See Matter of Simpson*, 36 F.3d 450 (5th Cir. 1994).⁷ A renunciation will not be considered a fraudulent transfer under 11 U.S.C. § 548(a). *Id.* The *Simpson* rule has been applied to renunciations of Louisiana inheritances in a district court tax case. *In re Brumfield, supra*. Louisiana law does not allow an heir to renounce before the death of the decedent. La. Civ. Code art. 949.

A “donative renunciation” in favor of a heir is deemed an acceptance of the inheritance. La. Civ. Code art. 960. Such renunciations would not remove the inheritance from the bankruptcy estate. 11 U.S.C. § 548 now authorizes the trustee to seek to avoid any *fraudulent* transfer of an interest property made within 2 years of the filing of the bankruptcy or a transfer for less than reasonable value that results in the debtor's insolvency.⁸ The 2005 bankruptcy amendments extended this look-back period from 1 to 2 years. Also, if an heir tacitly accepted the inheritance before a renunciation, the inheritance would be included in the bankruptcy estate. *Cf. In re Brumfield, supra*.

Several courts have held that post-petition renunciations do not remove the property from the bankruptcy estate. *See e.g., In re Schmidt, supra; Alford v. Reed*, (N.D. Tx. 2005); *In re Chenoworth*, 132 B.R. 161 (Bankr. S.D. Ill. 1991) *aff'd* 3 F.3d 1111 (7th Cir. 1993).

⁷ A recent Texas bankruptcy court suggests that the *Simpson* rule may no longer be valid. *In re Schmidt*, (Bankr. W.D. Tx. 2007). However, *In re Schmidt* acknowledges that the 5th Circuit has not overruled *Simpson*. Also, *Simpson* has been favorably cited by subsequent 5th Circuit decisions. *In re Lucas*, 104 Fed. Appx. 411 (5th Cir. 2004); *Leggett v. USA*, 120 F.3d 592 (5th Cir. 1997).

⁸ Also, the trustee has avoidance powers under state law by virtue of 11 U.S.C. § 544. *See* La. Civ. Code art. 2044.

In summary, a debtor may want to consider a renunciation before filing bankruptcy. To avoid inclusion in the bankruptcy estate, the renunciation must not be donative, i.e., directed in favor of another heir. Also, donations and quit-claim deeds will not work to transfer the inheritance to another person. There is some risk that even a pre-petition renunciation will be ineffective if the *Simpson* case is overruled by the 5th Circuit.