

## **BANKRUPTCY AND LOW INCOME HOUSING: WHERE IS THE VOICE OF THE TENANTS?**

The owner of a low income housing complex never really owns all the interests that exist in the property. The owner of the complex may have borrowed money to purchase the land or build improvements, giving one or more lenders mortgages on the complex, and the owner may seek income through leasing units, giving the tenants a possessory interest in the complex. A low income housing complex is also subject to the property interest of an additional party, the government, which provides financial assistance to ensure the continuing existence of affordable housing. When the owner of such a housing complex files for bankruptcy, each of these parties maintains an interest in the development. Unfortunately, because the owner's debts are greater than his assets, not every party will recover the full amount of its interest. The United States Bankruptcy Code ("Bankruptcy Code") attempts to protect the interests of all the parties. However, conflicting goals of the different parties silence the weakest voices. In the context of low income housing, the voices of the tenants are not heard.

The greatest conflict arises between the desires of the lenders and tenants. While lenders want to maximize revenue by charging the highest rent, the tenants want to maintain unit possession at the lowest possible rent. Similarly, if a bankruptcy plan requires the housing complex to be sold, the lenders want the complex sold with as few encumbrances as possible to gain the most money for the estate while the tenants want the property sold subject to the restrictions that benefit them.

The Bankruptcy Code protects lenders by requiring the appointment of a trustee.<sup>1</sup> The bankruptcy trustee acts as a representative of the bankruptcy estate and preserves the estate for the protection of the creditors, of which the lender is often the largest.<sup>2</sup> For example, the trustee has the power to assume or reject executory contracts and unexpired leases,<sup>3</sup> sell property of the estate free of certain encumbrances,<sup>4</sup> and avoid fraudulent or preferential transfers<sup>5</sup> in

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<sup>1</sup> 11 U.S.C. § 1104 (2000).

<sup>2</sup> *See id.* § 323(a). The trustee acts as a representative for the bankruptcy estate, and in doing so, ensures that as much of the debtor's property as possible comes into the estate to pay back the creditors. *Id.*

<sup>3</sup> *Id.* § 365.

<sup>4</sup> *Id.* § 363(f).

an attempt to maximize the value of the estate that will be distributed to the creditors, such as the lender.

The Bankruptcy Code attempts to protect tenants by allowing a tenant already in possession of a unit to remain in possession for the remainder of the lease term even if the lease has been rejected.<sup>6</sup> The debtor, by rejecting the lease, is no longer obligated by the lease terms.<sup>7</sup> Thus, tenants may remain in possession, but they cannot force the owner to meet the obligations in the lease agreement.<sup>8</sup>

By providing various forms of rent subsidies, mortgage insurance, or tax credits to the owners of low income housing complexes, the government steps into the shoes of a creditor and also provides protection to the tenants.<sup>9</sup> As a creditor, the government has a vote in how the trustee acts to serve the best interests of all the creditors,<sup>10</sup> however, the government is only one of many votes that decide how the property is used.<sup>11</sup> The shortcomings of these protections cause the voice of the lenders to drown out the voice of the tenants. The absence of tenants' voices in bankruptcy may encourage owners to file for bankruptcy to avoid low income housing restrictions, worsening the housing crisis for low income families.

To comprehend the problem bankruptcy creates for low income housing, it is essential to understand the different low income housing structures; the relationships these structures create among the owner, the tenants, and the government; and the Bankruptcy Code provisions that govern these relationships. Part I of this Comment describes three different low income housing structures: Section 8 rent subsidies, federally insured mortgages, and the low income housing tax credit. The specific powers of the bankruptcy court pertaining to tenants' leases and the trustee's power to sell property free and clear of any interest are also discussed in Part I. Part II discusses the consequences of the owner of a low income housing complex filing bankruptcy and illustrates the absence of the voice of the tenants in the proceedings.

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<sup>5</sup> *Id.* §§ 547–548.

<sup>6</sup> *Id.* § 365(h)(1)(A)(ii).

<sup>7</sup> *Id.* § 365(h)(1)(A).

<sup>8</sup> *Id.* § 365(h)(1)(B).

<sup>9</sup> *See infra* Part I.

<sup>10</sup> *See* 11 U.S.C. § 1109(b) (explaining any party in interest can “raise and may appear and be heard on any issue” in a chapter 11 reorganization case). As a party in interest, the government votes to accept or reject the reorganization plan. *Id.* § 1126(a).

<sup>11</sup> *See id.* § 501 (allowing a creditor to file a proof of claim); § 1126(a) (allowing the holder of a claim to vote to accept or reject a reorganization plan).

Finally, Parts III and IV suggest methods to introduce the tenants' voices into future bankruptcy proceedings. Part III recommends a change in the judicial interpretation of the Bankruptcy Code as an immediate solution and Part IV recommends a change in the drafting of low income housing documents as a long-term solution. These changes will protect the rights of the tenants and in turn give them a voice in bankruptcy.

## I. LOW INCOME HOUSING AND BANKRUPTCY BACKGROUND

Low income housing programs are complex legal structures that involve multiple parties and are subject to many regulations. Each program creates specific obligations among the government, the owner of the property, and the tenants, and implements different recording systems to ensure enforcement of these obligations.<sup>12</sup> How the obligations are documented and recorded determines which section of the Bankruptcy Code resolves whether the obligations will survive the property owner's bankruptcy. This Part examines the specific agreements recorded for each of the three different federal housing programs and provides an overview of the Bankruptcy Code provisions that relate to these agreements.

### A. *Low Income Housing*

The federal government provides many different financial assistance programs for low income families in need of housing.<sup>13</sup> Congress has established programs including rent subsidies, federally insured mortgages, and tax credits.<sup>14</sup> While Congress places the responsibility of implementing these programs on federal, state, and local organizations,<sup>15</sup> this Comment focuses on the low income housing programs that involve agreements between federal organizations, property owners, and low income tenants.<sup>16</sup>

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<sup>12</sup> See generally BARRY G. JACOBS ET AL., GUIDE TO FEDERAL HOUSING PROGRAMS (The Bureau of Nat'l Affairs, Inc. ed., 1982).

<sup>13</sup> See *id.* at 11. The Housing Act of 1949 "established a firm federal commitment to housing." *Id.*

<sup>14</sup> See *infra* Part I.A.1-3.

<sup>15</sup> For example, local housing authorities have the power to offer low interest rate loans because of their ability to issue tax-exempt notes and bonds. See JACOBS, *supra* note 12, at 48.

<sup>16</sup> HUD is responsible for entering into Section 8 housing agreements and insuring Section 221(d) mortgages, while state credit agencies are responsible for allocating federal low income housing tax credits. See JAMES W. JONES, MULTIFAMILY HOUSING: FEDERAL PROGRAMS FOR THE PRIVATE SECTOR §§ 2.02, 4A.02[2], 5.05[1] (Law Journal Seminars-Press 1986) (explaining that HUD runs Section 8 programs and insures Section 221(d) mortgages, while state credit agencies allocate tax credits).

### 1. Section 8 Housing

The government's Section 8 Housing Vouchers Program provides a rent subsidy to low income families for housing in preexisting buildings.<sup>17</sup> The U.S. Department of Housing and Urban Development ("HUD") provides funding to Public Housing Authorities ("PHA"),<sup>18</sup> which in turn award "certificates" or "vouchers" to property owners, which carry a commitment that the government will pay a portion of the tenant's rent directly to a landlord.<sup>19</sup> A family presents the voucher to a landlord, and if the landlord is willing to accept it, the voucher becomes a contractual agreement between the landlord and the PHA.<sup>20</sup>

The Section 8 Housing Vouchers Program creates a typical landlord-tenant relationship between the property owner and the low income family. The family signs a lease agreement with the owner for a set period at a specified rent.<sup>21</sup> The lease agreement between the Section 8 tenant and the owner has all of the same requirements and restrictions that a lease agreement between the owner and an ordinary tenant would include.<sup>22</sup> The only difference is that HUD pays the voucher amount to the landlord and the tenant pays the remainder.<sup>23</sup>

Owners who agree to accept a Section 8 voucher also have obligations to the government.<sup>24</sup> The PHA enters into a Housing Assistance Payments contract ("HAP contract") with each individual owner.<sup>25</sup> The HAP contract provides that the PHA is obligated to pay the difference between the monthly

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<sup>17</sup> 3 [Reference File] Hous. & Dev. Rep. (West) § 17, 17-2 (July 2005).

<sup>18</sup> JACOBS, *supra* note 12, at 43. PHA must submit proposals to HUD explaining the area's need for Section 8 funding to receive funding. *Id.* HUD then enters into an "Annual Contributions Contract" with the PHA based on the area's need for assistance. *Id.*

<sup>19</sup> 3 [Reference File] Hous. & Dev. Rep. (West) § 17, 17-2 (July 2005). PHA also solicit applications from low income families to determine which families are in the greatest need of Section 8 funding. JACOBS, *supra* note 12, at 43.

<sup>20</sup> 3 [Reference File] Hous. & Dev. Rep. (West) § 17:7 (July 2005).

<sup>21</sup> *Id.* § 17:8 (the voucher program allows a family to negotiate the rent with the owner of the housing).

<sup>22</sup> See ANDREW CUOMO, SECTION 8 TENANT-BASED HOUSING ASSISTANCE: A LOOK BACK AFTER 30 YEARS 5-6 (HUD ed., 2000) (explaining that a family can choose what apartment to rent in any jurisdiction).

<sup>23</sup> *Id.* at 5. HUD sets the standard voucher amount for a Section 8 family by determining the fortieth percentile of the fair market rent for standard-quality units in the neighborhood chosen by the family based on new leases for the previous year and subtracting 30% of the family's adjusted income. *Id.* If a family chooses housing where the rent exceeds the fair market standard, the family is responsible for paying the extra rent. *Id.*

<sup>24</sup> JACOBS, *supra* note 12, at 27.

<sup>25</sup> *Id.*

rent paid by the Section 8 tenant and the fair market rental value for the unit.<sup>26</sup> The term of the HAP contract is the same as the lease term specified in the lease agreement between the owner and the Section 8 tenant.<sup>27</sup> Since the PHA pays the owner directly each month, the Section 8 tenant has little direct interaction with the PHA after the agency has granted the tenant a Section 8 voucher.<sup>28</sup>

At one time, a housing developer could apply directly to HUD for a HAP contract prior to building the housing complex rather than having to wait until the complex was completed and occupied by Section 8 tenants.<sup>29</sup> Since the only difference between the new construction program and the voucher program was that the developer applied for a HAP contract rather than the owner of an existing housing complex, the relationships between the tenant and the owner and between the tenant and the government remained the same as in a Section 8 Voucher Program. Even though the developer would have applied for the HAP contract prior to construction, the benefits received from the contract remained the same as in Section 8 vouchers.<sup>30</sup> Unlike the Section 8 Voucher Program, the term of the HAP contract was not the same as the lease term agreed to by the owner and the Section 8 tenant.<sup>31</sup> The term of the HAP contract ranged from twenty to forty years based on the type of financing the developer received to build the housing complex.<sup>32</sup> The HAP contract also specified the number of low income housing units the developer needed to reserve for Section 8 tenants.<sup>33</sup>

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<sup>26</sup> See *id.* at 29-31.

<sup>27</sup> *Id.* at 45. HAP contracts in Section 8 voucher arrangements usually run between one and three years. *Id.*

<sup>28</sup> See *id.*

<sup>29</sup> *Id.* at 34. The developer's proposal to HUD needed to include the chosen location, the type of housing being constructed, and the financing the developer received. *Id.*

<sup>30</sup> See *id.* at 40. The developer did not receive federal financing for construction of the complex by directly applying for a HAP contract; the developer and HUD agreed that, after the project was completed, the developer would rent a specific number of units to Section 8 tenants and HUD would pay the developer the required rent subsidies. See *id.* at 36, 39-40.

<sup>31</sup> *Id.* at 33.

<sup>32</sup> *Id.* If the developer financed the project through a Federal Housing Administration-insured mortgage, the length of the HAP contract was twenty years; if the developer sought conventional financing, the contract term was thirty years; and if the developer financed the project through the state housing finance agency, the contract term was forty years. *Id.*

<sup>33</sup> See *id.* at 40. Under the HAP contract, HUD must pay 80% of the rent for units earmarked for Section 8 housing if the units are vacant rather than allowing the developer to rent to another tenant. *Id.* at 39-40. If the complex has many vacancies, HUD can reduce the number of units serviced under the HAP contract, allowing the developer to rent to other tenants. *Id.*

Section 8 housing accounted for over 60% of government housing assistance for the 2003 fiscal year.<sup>34</sup> Concern over the budget deficit led Congress to repeal the Section 8 New Construction and Rehabilitation Program and increase the tenant-based Section 8 programs, but since new construction HAP contracts last for twenty to forty years, many are still in effect.<sup>35</sup> Out of the 3,371,599 housing units subsidized by Section 8 funding, the government supports 2,051,967 units by vouchers and 1,319,632 by new construction HAP contracts.<sup>36</sup> The housing assistance programs currently serve only 32% of eligible low income households and new applicants must wait thirty-five months to receive Section 8 vouchers.<sup>37</sup>

HAP contracts and individual lease agreements ensure affordable housing by giving the government and the individual tenants a claim against the property owner if he breaches either agreement. The question is whether the parties retain their right to bring that claim if the owner files for bankruptcy.

## 2. Section 221(d)(3) and 221(d)(4): FHA Insured Loans

In 1949, Congress recognized the private sector's role in realizing the congressional goal of providing a "decent home and suitable living environment for every American family"<sup>38</sup> by creating federal programs that granted direct governmental loans to developers of low income housing.<sup>39</sup> Under section 221 of the Housing and Development Act, HUD granted below market interest rate mortgages to private developers to encourage development of housing for low income families.<sup>40</sup> These loan agreements created intricate relationships between HUD and the developers<sup>41</sup> while maintaining a

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<sup>34</sup> HUD Provided Assistance to Over 5.3 Million Households, Units in 2003, Performance Report Says, 32 [Current Developments] Hous. & Dev. Rep. (West) 19, 19 (Jan. 5, 2004) [hereinafter *HUD Provided Assistance*].

<sup>35</sup> 3 [Reference File] Hous. & Dev. Rep. (West) § 17:1 (July 2005). Section 209 of the Housing and Urban-Rural Recovery Act of 1983 repealed authorization for Section 8 New Construction and introduced the Section 8 Voucher Program. *Id.*

<sup>36</sup> HUD Provided Assistance, *supra* note 34, at 19.

<sup>37</sup> Lack of Affordable Housing Leading Cause of Homelessness, Says Survey Released by Mayors, 32 [Current Developments] Hous. & Dev. Rep. (West) 810, 811 (Dec. 20, 2004).

<sup>38</sup> 42 U.S.C. § 1441 (2000).

<sup>39</sup> Congress enacted Section 221(d)(3) as a Below Market Interest Rate Program. 3 [Reference File] Hous. & Dev. Rep. (West) §15:20, 15-7 (July 2005).

<sup>40</sup> JACOBS, *supra* note 12, at 17.

<sup>41</sup> The relationship between HUD and the developer is created through a regulatory agreement that outlines how the housing project will operate and includes the Low Income Affordability Restriction. 24 C.F.R. § 248.101 (2005).

traditional landlord-tenant relationship for the low income families.<sup>42</sup> Although abolished in 1968,<sup>43</sup> Section 221(d)(3) and 221(d)(4) programs still exist in the form of governmental mortgage insurance to private developers building low income housing.<sup>44</sup>

The Federal Housing Administration (“FHA”), a department of HUD, insures loans made to developers by private, HUD-approved lenders.<sup>45</sup> FHA-insured loans are nonrecourse, long term, fixed-rate loans that have lower interest rates due to the federal guarantee.<sup>46</sup> Section 221(d)(3) provides a nonprofit organization with insurance covering 100% of the FHA’s estimate of the project replacement cost, while 221(d)(4) provides a private developer with insurance covering 90% of the project replacement cost.<sup>47</sup> Both sections allow for a mortgage term of up to forty years or three-fourths of the project’s economic life, whichever is shorter.<sup>48</sup>

In exchange for these benefits, developers must sign a regulatory agreement with HUD governing the operation of the housing development.<sup>49</sup> HUD gains a security interest in the housing development by incorporating the regulatory agreement into the mortgage the developer receives from the private mortgagee.<sup>50</sup> To meet the requirements of the National Housing Act, HUD uses the authority granted to it by Congress by having mortgagors sign regulatory agreements that restrict the mortgagor as to rents, sales, capital structure, rate of return, and methods of operation.<sup>51</sup> The use of the regulatory agreement also requires the private mortgagee to convey the property title to the HUD Commissioner if the mortgagee forecloses on the property.<sup>52</sup> The

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<sup>42</sup> See *supra* text accompanying notes 21-23.

<sup>43</sup> The Housing and Urban Development Act of 1968 replaced the Section 221 loan with Section 236 housing. 3 [Reference File] Hous. & Dev. Rep. (West) § 15:20, 15-7.

<sup>44</sup> *Rental Housing for New Construction and Substantial Rehabilitation Section 221(d)(3) and Section 221(d)(4)*, HUD FACT SHEET (1996), available at <http://www.hud.gov> [hereinafter HUD FACT SHEET].

<sup>45</sup> 12 U.S.C. § 1715l (2000).

<sup>46</sup> HUD FACT SHEET, *supra* note 44. The private mortgagee and mortgagor determine the interest rate without HUD approval, however, it is often a lower rate than the mortgagor could have received without the federal insurance because the guarantee results in an AAA rating on financing. *Id.*

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

<sup>48</sup> 24 C.F.R. § 200.82 (2005).

<sup>49</sup> *Id.* “[T]he Commissioner shall regulate the mortgagor by means of a regulatory agreement providing terms, conditions, and standards established by the Commissioner, or by such other means as the Commissioner may prescribe.” 24 C.F.R. § 200.105.

<sup>50</sup> See *In re Garden Manor Assocs.*, 70 B.R. 477, 483 (Bankr. N.D. Cal. 1987) (holding HUD’s regulatory agreement becomes a lien on real property when the agreement is recorded in the official records).

<sup>51</sup> *Id.*; see 12 U.S.C. § 1715v(c)(4) (2000).

<sup>52</sup> 24 C.F.R. § 248.103(c).

regulatory agreement remains on the property while the original HUD-insured mortgage is in effect.<sup>53</sup> HUD-insured mortgages often allowed prepayment, but by prepaying the mortgage the owner of the development no longer needed to abide by the rent restrictions within the regulatory agreement.<sup>54</sup> For this reason, Congress passed the Low-Income Housing Preservation and Resident Homeownership Act of 1990.<sup>55</sup> This Act requires the owner of a low income housing project to receive approval from the HUD Commissioner before prepaying or terminating a HUD-insured mortgage.<sup>56</sup>

By incorporating the regulatory agreement in the recorded private mortgage, the government ensures that the owner will operate the housing development as low income housing. The owner cannot breach the agreement for fear that HUD will foreclose due to noncompliance.<sup>57</sup> Also, the recording of the regulatory agreement gives notice to any prospective buyer that the property is subject to low income housing restrictions.<sup>58</sup>

### 3. *Low Income Housing Tax Credit*

The Low Income Housing Tax Credit is the newest governmental incentive for private developers to build low income housing units. Created and administered by the Internal Revenue Service (“IRS”) rather than HUD, this program grants a tax credit to a taxpayer responsible for the acquisition, rehabilitation, or construction of low income housing.<sup>59</sup> To be entitled to the tax credit, the complex owner must rent a certain percentage of the units at a restricted rent to people whose income is below the area median.<sup>60</sup> By meeting

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<sup>53</sup> National Low Income Housing Coalition, *Background on Mortgage Prepayment Crisis* (1999), <http://www.nlihc.org/press/back.htm> (last visited Sept. 25, 2005).

<sup>54</sup> *Id.*

<sup>55</sup> 12 U.S.C. §§ 4101-4147.

<sup>56</sup> 24 C.F.R. § 248.103(a). Without filing a letter of intent with the commissioner, 24 C.F.R. § 248.105, any prepayment is null and void and all low income affordability restrictions remain on the property, 24 C.F.R. § 248.103(d).

<sup>57</sup> HUD, *Model Form Regulatory and Operating Agreement* art. 6, 17-18, (Draft Jan. 2003), <http://www.hud.gov/offices/pih/programs/ph/hope6/mfph/randoagreementallph.doc> (last visited Sept. 25, 2005).

<sup>58</sup> *See id.* art. 10.2, at 19 (stating that the form regulatory and operating agreement is binding upon successors and assigns).

<sup>59</sup> JONES, *supra* note 16, at 4A-6.

<sup>60</sup> 26 U.S.C. § 42(g) (2000). For an owner to meet the occupancy requirement for the tax credit, the owner must rent 20% of the residential units at a restricted rent to individuals whose income is 50% or less of the area’s median gross income, or the owner must rent 40% or more of the residential units to individuals whose income is 60% or less of the area’s median gross income. *Id.* To meet the rent restriction, the owner cannot charge more than 30% of the percentage of the area’s median income the owner chose as his

the occupancy and rent requirements, the owner can reduce his tax liability over a ten-year period by either 30% or 70% of the building cost.<sup>61</sup> Even though the owner only receives the tax credit for ten years, the housing development, pursuant to the extended low income housing commitment between the taxpayer and the state housing credit agency, is subject to the occupancy requirements for at least thirty years.<sup>62</sup>

The IRS allocates tax credits to each state at a maximum of \$1.25 per state resident.<sup>63</sup> The state housing credit agency then allocates these credits to qualified developers who apply for the tax credits.<sup>64</sup> Developers apply for state tax credits to raise equity for their projects.<sup>65</sup> Rather than seeking private financing, developers sell their tax credits to investors who wish to offset their tax liability.<sup>66</sup> Developers typically sell 99% of their equity interest in the tax credit to finance the project, but they retain an ownership interest as general partners who guarantee the investment performance.<sup>67</sup>

Each owner of an equity interest in the tax credit development must receive a Low Income Housing Tax Credit Certification every year to claim the tax credit.<sup>68</sup> The owner gains certification for the first year the credit is claimed by having the state housing credit agency file a Form 8609, which certifies compliance with the requirements for the tax credit.<sup>69</sup> However, the state agency will not file a Form 8609 with the IRS until the owner signs an extended low income housing commitment that requires the owner to comply with the occupancy and rent restrictions for an additional fifteen years.<sup>70</sup> The

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benchmark in meeting the occupancy requirement (30% or 50% of the median income or 60% of the median income). JONES, *supra* note 16, at 4A-17.

<sup>61</sup> JONES, *supra* note 16, at 4A-17. The owner of a newly constructed building using additional federal subsidies can reduce tax liability by 30%, while the owner of a newly constructed building that does not use additional federal subsidies can reduce tax liability by 70%. NOVGRADAC & CO. LLP, *LOW INCOME HOUSING TAX CREDIT HANDBOOK 8* (2005) [hereinafter *TAX CREDIT HANDBOOK*]. An owner can claim the credit pro rata over the ten-year period. *Id.* at 1.

<sup>62</sup> 26 U.S.C. § 42(h)(6)(D). The minimum extended use period is fifteen years. *Id.*

<sup>63</sup> Susan Hobart & Robert Schwarz, *History of the Tax Credit*, URB. LAND, Nov. 1997, at 49.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* at 79. Investors are willing to pay sixty to seventy cents per credit dollar towards the building of the housing project in exchange for the ten-year tax credit. *Id.* at 49.

<sup>67</sup> *Id.* at 79.

<sup>68</sup> *TAX CREDIT HANDBOOK*, *supra* note 61, at 55.

<sup>69</sup> *See id.* at 174-75. Form 8609 contains the qualified basis of the building and the eligible basis of the building. *Id.*

<sup>70</sup> *See, e.g.*, Minnesota Housing Finance Agency, *Declaration of Land Use Restrictive Covenants for Housing Tax Credits 2004 Allocation Year*, (2004), [http://www.mhfa.state.mn.us/multifamily/2004\\_Declaration\\_Land\\_Use.rtf](http://www.mhfa.state.mn.us/multifamily/2004_Declaration_Land_Use.rtf) (last visited Sept. 25, 2005) [hereinafter *Minnesota Tax Credit Program*];

IRS also demands that the extended commitment agreement include certain terms, such as the fraction of the complex reserved for low income tenants, the right of tenants to enforce the specified fraction in state court, and the prohibition on owners refusing housing to Section 8 tenants because of their Section 8 status.<sup>71</sup> The state agency must also require the owner to record the commitment pursuant to state law as a restrictive covenant before it can send a Form 8609 to the IRS.<sup>72</sup> By recording the commitment, the occupancy and rent restrictions become restrictive covenants that run with the land and bind not only the owner but also the owner's successors and assigns.<sup>73</sup>

However, the IRS allows an owner to terminate the commitment after the fifteen year compliance period by properly opting out of the extended low income use agreement.<sup>74</sup> To terminate the restrictive covenants, the owner must contact the state housing agency at the end of the fourteenth year of the compliance period and express his intention to opt out of the program.<sup>75</sup> If the state housing agency cannot find someone during the fifteenth year of the compliance period who will contract to continue operating the development as low income housing, the extended low income housing commitment is terminated.<sup>76</sup> The tenants of the development are protected for an additional three years because the Internal Revenue Code will not allow the following:

[B]efore the close of the [three] year period following such termination (I) the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low-income unit, or (II) any increase in the gross rent with respect to such unit not otherwise permitted under [§ 42].<sup>77</sup>

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Nevada Housing Agency, *Low Income Housing Tax Credit (LIHTC) Program Compliance Manual*, (2004), [http://www.nvhousing.state.nv.us/tax\\_credit/LIHTC%20Manual%202004%20master.pdf](http://www.nvhousing.state.nv.us/tax_credit/LIHTC%20Manual%202004%20master.pdf) (last visited Sept. 25, 2005) [hereinafter Nevada Tax Credit Program]. The IRS will not grant a tax credit unless an owner signs an extended low income housing commitment by the end of the taxable year. 26 U.S.C. § 42(h)(6)(A) (2000).

<sup>71</sup> 26 U.S.C. § 42(h)(6)(B).

<sup>72</sup> *Id.* § 42(h)(6)(B)(v)-(vi); see, e.g., Minnesota Tax Credit Program, *supra* note 70; Georgia Department of Community Affairs, *Declaration of Land Use Restrictive Covenants for Low Income Housing Tax Credits* (2005) (on file with author) [hereinafter LURC].

<sup>73</sup> 26 U.S.C. § 42(h)(6)(B)(v). The commitment covenants are not personal covenants. Minnesota Tax Credit Program, *supra* note 70.

<sup>74</sup> TAX CREDIT HANDBOOK, *supra* note 61, at 202.

<sup>75</sup> 26 U.S.C. § 42(h)(6)(I); LURC, *supra* note 72.

<sup>76</sup> 26 U.S.C. § 42(h)(6)(E)(i)(II). The commitment also terminates upon foreclosure of the property. *Id.* § 42(h)(6)(E)(i)(I).

<sup>77</sup> *Id.* § 42(h)(6)(E)(ii).

The government ensures compliance with the low income housing tax credit restrictions through restrictive covenants and tax forms. The extended low income housing commitment attaches an enforceable property interest to the tax credit.<sup>78</sup> The recording of the covenants allows state agencies and tenants to sue the owner for breaching the low income restrictions during the thirty-year period.<sup>79</sup> The IRS also ensures compliance by requiring the owner to file a Form 8586 each year the owner claims the tax credit and a Form 8609 each year during the fifteen-year compliance period to prove compliance with the low income restrictions.<sup>80</sup> If the property owner does not comply with the tax credit requirements or disposes of his interest in the low income building anytime during the fifteen-year minimum compliance period, the IRS can recapture as much as one-third of the prior credits the owner claimed plus interest.<sup>81</sup>

### *B. Bankruptcy Code Sections*

Just as the aforementioned low income housing agreements provide low income tenants assurance that their housing will remain affordable, the Bankruptcy Code assures a property owner that he can maximize the value of his estate. The Bankruptcy Code provides such protection by including sections that prohibit parties from bringing actions to collect against a debtor,<sup>82</sup> allow the trustee to reject burdensome executory contracts,<sup>83</sup> and permit the trustee to sell property of the bankruptcy estate free of other parties' interests.<sup>84</sup>

#### *1. The Automatic Stay*

The automatic stay provides protection to the debtor by giving the debtor a "breathing spell" from creditors.<sup>85</sup> It prohibits creditors' collection efforts,

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<sup>78</sup> See *id.* § 42(h)(6)(B)(vi).

<sup>79</sup> *Id.* § 42(h)(6)(B)(ii).

<sup>80</sup> See TAX CREDIT HANDBOOK, *supra* note 61, at 192.

<sup>81</sup> *Id.* at 245. If the owner does not comply with the requirements in years two through eleven of the compliance period, one-third of the claimed credits are recaptured; if failure to comply occurs in year twelve, four-fifteenths of the claimed credits are recaptured; if failure to comply occurs in years thirteen, fourteen, or fifteen, three-fifteenths, two-fifteenths, and one-fifteenth of the claimed credits are recaptured, respectively. *Id.* at 247-48.

<sup>82</sup> 11 U.S.C. § 362 (2000).

<sup>83</sup> *Id.* § 365.

<sup>84</sup> *Id.* § 363(f).

<sup>85</sup> H.R. REP. NO. 95-595, at 343 (1978), as reprinted in 1978 U.S.C.C.A.N. 5963, 6296-97.

harassment, and foreclosure actions.<sup>86</sup> Congress did recognize that, for public policy reasons, there are certain actions that a bankruptcy proceeding should not stall.<sup>87</sup> These exceptions include the following: commencing or continuing a criminal action against the debtor, commencing or continuing an action to establish paternity or alimony, collecting alimony, enforcing a governmental unit's police or regulatory power, and commencing a case to foreclose a HUD mortgage or deed of trust.<sup>88</sup> If a creditor's action does not fall within one of the exceptions, the creditor may request that the court grant relief from the stay for "cause."<sup>89</sup> Unfortunately, great ambiguity exists as to the specific government actions that fall within the police power exception, as well as to the definition of cause under Bankruptcy Code § 362(d).

## 2. *Rejecting Executory Contracts*

The Bankruptcy Code gives the trustee the option to assume, assume and assign, or reject any of the debtor's executory contracts or unexpired leases.<sup>90</sup> An executory contract is defined as a contract in which "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."<sup>91</sup> The rejection of an executory contract or unexpired lease releases the trustee from any obligations within the agreement, but rejection does not relieve the estate of liability for breach of the agreement.<sup>92</sup> In accordance with the Bankruptcy Code, bankruptcy courts treat rejection of a contract as an anticipatory breach and hold debtors liable for damages.<sup>93</sup> Unfortunately, the creditor who suffers the breach is placed in the

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<sup>86</sup> *Id.* The automatic stay prohibits any creditor from doing the following: commencing or continuing a judicial or administrative proceeding against the debtor that the creditor could have commenced prior to the debtor's commencement of the bankruptcy action, enforcing a judgment obtained before the commencement of the bankruptcy against the debtor or against property of the estate, obtaining possession or control of property of the estate, or collecting a claim against the debtor that arose before the commencement of the bankruptcy case. 11 U.S.C. § 362(a).

<sup>87</sup> *Chao v. Hosp. Staffing Servs., Inc.*, 270 F.3d 374, 385 (6th Cir. 2002). "Congress declared that the policy set forth in the Bankruptcy Code's automatic stay provision yields to state and federal governmental interests in securing compliance with certain aspects of those authorities' respective regulatory and police powers." *Id.*

<sup>88</sup> 11 U.S.C. § 362(b).

<sup>89</sup> *Id.* § 362(d). For a court to grant a creditor relief from the automatic stay, the creditor must show cause, such as his secured interest is not adequately protected or that the collateral is not necessary for the debtor's successful reorganization. *Id.*

<sup>90</sup> *Id.* § 365.

<sup>91</sup> Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

<sup>92</sup> 11 U.S.C. § 365(g).

<sup>93</sup> *See id.*

class of unsecured creditors and thus likely to receive very little compensation.<sup>94</sup>

### 3. Power to Sell Property Free of Other Interests

The trustee also has the power to sell property of the estate free and clear of any interest if certain requirements are met.<sup>95</sup> The Bankruptcy Code still puzzles most courts in terms of what types of property interests can be stripped from the estate.<sup>96</sup> Congress seemed to intend the statute to allow trustees to sell property of the bankruptcy estate free of mortgages,<sup>97</sup> but the broad language of the statute leads some trustees to argue that they may sell property of the bankruptcy estate free and clear of any interest in the property.<sup>98</sup> Even though nonbankruptcy courts view covenants, easements, and other *in rem* interests as property interests,<sup>99</sup> bankruptcy courts are reluctant to allow a trustee to strip these interests from a piece of property.<sup>100</sup> The two subsections under § 363 that trustees argue allow the sale of property free and clear of *in rem* interests are the following: § 363(f)(1), which allows the sale if applicable nonbankruptcy law would allow the sale free and clear of the interest, and § 363(f)(5), which allows sale of the property free and clear of the interest if

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<sup>94</sup> Robertson v. Pierce (*In re* Chi-Feng Huang), 23 B.R. 798, 803 (B.A.P. 9th Cir. 1982).

<sup>95</sup> 11 U.S.C. § 363(f). A trustee can sell property of the estate free and clear of all interests if: (1) applicable nonbankruptcy law permits the sale of the property free of the interests, (2) the entity holding the interest consents, (3) the interest is a lien and the trustee will receive a price from the sale that is greater than the aggregate value of all liens on the property, (4) the interest is in bona fide dispute, or (5) the trustee can compel the entity holding the interest to accept a monetary satisfaction of the interest through a legal or equitable proceeding. *Id.*

<sup>96</sup> See Basil H. Mattingly, *Sale of Property of the Estate Free and Clear of Restrictions and Covenants in Bankruptcy*, 4 AM. BANKR. INST. L. REV. 431, 438-45 (1996).

<sup>97</sup> *Id.* at 437. The legislative history of § 363(f) states, “[s]ale under this subsection is subject to the adequate protection requirement. Most often, adequate protection in connection with a sale free and clear of other interests will be to have those interests attach to the proceeds of the sale,” implying that the interest is a lien on the property. H.R. REP. NO. 95-595, at 5 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6302.

<sup>98</sup> Mattingly, *supra* note 96, at 437. A careful reading of § 363 using the broad definition of property interest makes it difficult to think of an interest that does not fit within one of the limitations expressed in § 363(f). *Id.* at 447.

<sup>99</sup> Gouveia v. Tazbir, 37 F.3d 295, 298 (7th Cir. 1994) (holding that restrictive covenants are considered property interests even though a covenant has the characteristics of both a contract and a property interest).

<sup>100</sup> George W. Kuney, *Further Misinterpretation of Bankruptcy Code Section 363(f): Elevating In Rem Interests and Promoting the Use of Property Law to Bankruptcy-Proof Real Estate Developments*, 76 AM. BANKR. L.J. 289, 298-99 (2002). Courts explain that trustees may not strip the property of *in rem* interests because the interest is so ingrained in the asset that the interest cannot be separated from the property. *Id.* at 299.

the trustee can convince the interest holder to accept monetary satisfaction for the interest.<sup>101</sup>

Unfortunately, the protections these Bankruptcy Code sections provide property owners can destroy the protections housing agreements give low income tenants. While the aforesaid Bankruptcy Code sections protect the bankruptcy estate and include measures to protect the creditors of the estate from losing their interests in the property, they fail to protect the rights of the tenants.

## II. BANKRUPTCY AND LOW INCOME HOUSING

Low income housing programs are commonly structured through contracts and mortgages between governmental entities and private property owners.<sup>102</sup> These agreements restrict the use of property and create contract and property rights for the government.<sup>103</sup> Low income families are the intended beneficiaries of the low income housing initiative, and contract rights, if not property rights, also arise between the owner and such families.<sup>104</sup> When the owner of low income housing files for bankruptcy, the owner's obligations under the governmental agreements and the lease agreements with tenants are governed by § 365 of the Bankruptcy Code. Additionally, the extent of the government's interest in the owner's property is addressed by § 363(f).<sup>105</sup>

### A. Section 8 Bankruptcy

If the owner of an apartment complex that has Section 8 contracts files for bankruptcy, the rights of the parties are governed by the Bankruptcy Code.<sup>106</sup> Even if the trustee chooses to reject the lease of a Section 8 tenant already in possession of the apartment, the tenant has the right to stay in possession of his apartment by continuing to pay the contract rent for the remainder of the lease term.<sup>107</sup> The Bankruptcy Code allows a creditor to retain rights that are

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<sup>101</sup> Mattingly, *supra* note 96, at 450-52.

<sup>102</sup> See generally *supra* Part I.A.

<sup>103</sup> See generally *supra* Part I.A.

<sup>104</sup> See generally *supra* Part I.A.

<sup>105</sup> See *supra* Part I.B.

<sup>106</sup> 11 U.S.C. § 365(h) (2000).

<sup>107</sup> *Id.* § 365(h)(1)(A)(ii).

appurtenant<sup>108</sup> to the real property,<sup>109</sup> and these rights include the right to stay in possession of the property for the remaining period of the lease agreement.<sup>110</sup> This section causes confusion, however, because the Bankruptcy Code does not clearly identify which rights are considered appurtenant to real property. For example, courts disagree on whether restrictive covenants and other lease restrictions within a lease agreement are appurtenant to the real property.<sup>111</sup> While one bankruptcy court has argued that a bankruptcy trustee cannot avoid restrictive covenants that are enforceable under applicable non-bankruptcy law,<sup>112</sup> another court has held that restrictive covenants are not part of the possessory right because the contents of a leasehold estate are limited to possession, term, and rent.<sup>113</sup> Since the leasehold estate includes the specified rent obligation, the Bankruptcy Code prohibits the trustee from increasing property rent after the rejection of an unexpired lease.<sup>114</sup>

Therefore, the housing complex will only remain affordable for the low income families for the remainder of the families' leases.<sup>115</sup> Unfortunately, because most leases are for only one year, the tenant is only ensured affordable housing for one year.<sup>116</sup> Further, once the lease is rejected the tenant has no cause of action against the landlord for failure to meet his obligations under the lease.<sup>117</sup> Thus, if the landlord fails to pay the water bill and the water is shut

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<sup>108</sup> Appurtenant means “[a]nnexed to a more important thing.” BLACK’S LAW DICTIONARY 98 (7th ed. 1999). An appurtenant interest in property is one that benefits the particular piece of property regardless of the identity of the owner. CURTIS BERGER, LAND OWNERSHIP AND USE 532 (3d ed. 1983).

<sup>109</sup> 11 U.S.C. § 365(h)(1)(A)(ii).

<sup>110</sup> *Id.*; *In re A.J. Lane & Co.*, 107 B.R. 435, 437 (Bankr. D. Mass. 1989) (holding that a person is entitled to remain in possession of the property as long as he continues to make payments under the contract).

<sup>111</sup> Bruce Grohsgal, *Landlord’s Lease Rejection Under the Bankruptcy Reform Act of 1994*, AM. BANKR. INST. J., Jan. 1995, at 20, available at WESTLAW, 13-JAN AMBKRIJ 20.

<sup>112</sup> *In re Bedford Square Assocs.*, 247 B.R. 140, 145 (Bankr. E.D. Pa. 2000).

<sup>113</sup> *In re Arden & Howe Assocs.*, 152 B.R. 971, 974 (Bankr. E.D. Cal. 1993).

<sup>114</sup> 11 U.S.C. § 365(h)(1)(A)(ii); see *Upland/Euclid, Ltd. v. Grace Rest. Co. (In re Upland/Euclid, Ltd.)*, 56 B.R. 250, 252 (B.A.P. 9th Cir. 1985) (holding that the debtor may reject a lease and refuse to provide any services required under the lease agreement, however, the debtor may not “deprive the lessee of its possessory property interest in the leased premises.”).

<sup>115</sup> See *In re Upland/Euclid*, 56 B.R. at 250.

<sup>116</sup> For example, the Oakland Housing Authority reports that Section 8 lease terms are normally one year. Oakland Housing Authority Section 8, Frequently Asked Questions, [http://www.oakha.org/section8lh/faq.shtml#lease\\_length](http://www.oakha.org/section8lh/faq.shtml#lease_length) (last visited Sept. 24, 2005). Section 8 leases must be for a term of at least one year. 24 C.F.R. § 982.309 (2005).

<sup>117</sup> 11 U.S.C. § 365(h)(1)(B). The only action a tenant has is to offset the rent by the value of the damage caused by the landlord’s failure to perform his obligations under the lease. *Id.*

off, the tenant has no cause of action against the landlord under the lease agreement.

Even though the lease may terminate between the landlord and the tenant, the property owner still has a HAP contract with the government.<sup>118</sup> The question is whether the HAP contract fits within the definition of an executory contract so that the trustee can reject it.<sup>119</sup> Under the Countryman definition, the HAP contract is an executory contract because neither the owner's promise to house low income families nor HUD's promise to pay the difference in rent is fulfilled until the end of the contract term.<sup>120</sup> By defining the HAP contract as an executory contract, the trustee of a bankruptcy estate can reject the contract, ultimately destroying the availability of Section 8 housing.<sup>121</sup> Under a Section 8 Voucher Program, the term of the HAP contract is equal to each individual tenant's lease term. Therefore, the government would lose the remainder of the bargained-for term if the owner rejects the contract.<sup>122</sup> However, since the Bankruptcy Code allows a Section 8 tenant to remain in possession of the unit for the remainder of the lease term at the specified price,<sup>123</sup> the government does not really lose what it bargained for under a Section 8 voucher HAP contract.

Unfortunately, in new construction Section 8 programs where the HAP contract term ranges twenty to forty years, the government loses a substantial portion of what it bargained for if the owner rejects the contract early in the term.<sup>124</sup> In this context, the tenant remains in possession for the remainder of the lease term, but once the tenant's lease expires, the owner is no longer required to preserve the housing as a low income development.<sup>125</sup>

The trustee must receive approval from the bankruptcy court to reject an executory contract.<sup>126</sup> The test for approval is derived from the U.S. Supreme Court decision *Group of Institutional Investors v. Chicago*,<sup>127</sup> which applied

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<sup>118</sup> See *supra* Part I.A.1.

<sup>119</sup> 11 U.S.C. § 365(a).

<sup>120</sup> See *supra* text accompanying note 91.

<sup>121</sup> 11 U.S.C. § 365(a). The rejection of the HAP contract terminates the contract which means the trustee no longer needs to rent the property to low income families. See *id.*

<sup>122</sup> See *supra* Part I.A.1.

<sup>123</sup> 11 U.S.C. § 365(h)(1)(A)(ii).

<sup>124</sup> See *supra* Part I.A.1.

<sup>125</sup> See *supra* Part I.A.1.

<sup>126</sup> 11 U.S.C. § 365(a).

<sup>127</sup> *Group of Investors v. Chi., Milwaukee, St. Paul, & Pac. R.R. Co.*, 318 U.S. 523, 550 (1943).

the business judgment rule.<sup>128</sup> Under the business judgment rule, the court will approve the trustee's rejection of a contract as long as the trustee's decision is not clearly erroneous and appears to enhance the debtor's estate.<sup>129</sup> Since *Institutional Investors*, the Supreme Court has commented that since the purpose of a chapter 11 bankruptcy is to successfully rehabilitate the debtor, a court should not approve rejection of an executory contract without finding that the rejection would serve this purpose.<sup>130</sup> The court should balance the interests of all affected parties to determine whether the rejection would assist the rehabilitation.<sup>131</sup> Even though Congress has not allowed the stricter test, courts continue to suggest that rejection of an executory contract should only be approved if the contract burdens the estate and a balancing of the equities favors rejection.<sup>132</sup> Implementing this test may prevent owners from rejecting new construction HAP contracts as the burden to the tenants of the rejection outweighs the benefits to the estate.

The government could also argue that the rejection of a HAP contract in the tenth year of a twenty-year contract is a material breach of the contract.<sup>133</sup> If the contract is not executory, the trustee does not have the power to reject the contract and the debtor must either perform or face a breach of contract action.<sup>134</sup> The debtor may choose to breach the contract in hopes that the automatic stay will prevent the government from enforcing the obligations.

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<sup>128</sup> See Bruce H. White, *Rejecting Executory Contracts: Is the Standard Changing?*, AM. BANKR. INST. J., Oct. 2004, at 24, available at WESTLAW, 23-OCT AMBKRIJ 24.

<sup>129</sup> *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1309 (5th Cir. 1985). The bankruptcy court places itself in the trustee's position and determines whether rejection of the contract is reasonable, which means likely to benefit the estate. *In re G Survivor Corp.*, 171 B.R. 755, 758 (Bankr. S.D.N.Y. 1994).

<sup>130</sup> *NLRB v. Bildisco*, 465 U.S. 513, 527 (1984), *superseded by statute*, Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333.

<sup>131</sup> *Id.* Congress rejected the Supreme Court's suggestion for a stricter test for all executory contracts by codifying the stricter test only in regards to collective bargaining agreements. 11 U.S.C. § 1113.

<sup>132</sup> See, e.g., Official Comm. of Unsecured Creditors of Mirant Corp. v. Potomac Elec. Power Co. (*In re Mirant Corp.*), 378 F.3d 511, 525 (5th Cir. 2004); *Robertson v. Pierce (In re Chi-Feng Huang)*, 23 B.R. 798, 801 (B.A.P. 9th Cir. 1982) (stating the basic policy of bankruptcy law is to spread the burden evenly among both those who may have loaned the debtor money and those who might have obtained a profit from dealing with him); *Butler v. Resident Care Innovation Corp.*, 241 B.R. 37, 45 (D.R.I. 1999) (recognizing that courts still rely on the business judgment rule test, but noting that some opinions have suggested that courts should apply the balancing of the equities test); *Monarch Tool & Mfg. Co. v. Monarch Prod. Sales Corp. (In re Monarch Tool & Mfg. Co.)*, 114 B.R. 134, 137 (Bankr. S.D. Ohio 1990) (holding that disproportionate damage to the other party to the contract provides a ground for disallowing rejection).

<sup>133</sup> See *supra* Part I.A.1. Under the Countryman definition of an executory contract, rejection of the contract must constitute a material breach. See *supra* text accompanying note 91.

<sup>134</sup> *In re EES Lambert Assocs.*, 62 B.R. 328, 336 (Bankr. N.D. Ill. 1986) (stating the debtor's ability to rid itself of burdensome postpetition contractual undertakings is limited to executory contracts).

There is an argument, however, that the government's action to enforce the HAP contract could be interpreted as an exception to the stay.<sup>135</sup>

The Bankruptcy Code gives a governmental unit the power to commence or continue an action to enforce its regulatory or police powers notwithstanding the automatic stay.<sup>136</sup> Congress intended the courts to read the exception narrowly to permit governmental units to protect the public health and safety while prohibiting the governmental unit from protecting its pecuniary interest in the debtor's property.<sup>137</sup> Many courts, however, read the plain language of the statute to allow all actions except enforcement of a money judgment to fall within the government's police powers.<sup>138</sup> Courts use two tests to determine whether the police power exception applies—the pecuniary purpose test and the public policy test.<sup>139</sup> In *In re Berg*,<sup>140</sup> the Ninth Circuit Court of Appeals explained that, under the pecuniary purpose test, a government action falls within the government's police power if the action relates primarily to public safety and welfare rather than the government's pecuniary interest in the debtor's property.<sup>141</sup> Similarly, the public policy test says that a government action falls within the police power if the action effectuates public policy rather than adjudicating private rights.<sup>142</sup> The Ninth Circuit Bankruptcy Appellate Panel held the action would fall within the government's police power if it satisfied either the pecuniary interest test or the public policy test.<sup>143</sup> Courts have held that while private parties may benefit financially from a

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<sup>135</sup> See 11 U.S.C. § 362(b)(4). A governmental unit may bring an action under the unit's police power as long as the governmental unit does not seek to enforce a monetary judgment. *Id.*

<sup>136</sup> A governmental unit includes any foreign or domestic government agency. *Id.* § 101(27).

<sup>137</sup> *Chao v. Hosp. Staffing Servs., Inc.*, 270 F.3d 374, 385 (6th Cir. 2002) (“Those proceedings which relate primarily to matters of public safety are excepted from the stay.”); *Berg v. Good Samaritan Hosp. (In re Berg)*, 230 F.3d 1165, 1167 (9th Cir. 2000) (stating that the question of sanctions falling within the police powers relies on whether the sanctions relate to a matter of public policy or the protection of the government's pecuniary interest); *United States v. Klein (In re Chapman)*, 264 B.R. 565, 569 (B.A.P. 9th Cir. 2001); see Kenneth N. Klee & Frank A. Merola, *Ignoring Congressional Intent: Eight Years of Judicial Legislation*, 62 AM. BANKR. L.J. 1, 5 (1988). The police power exception ensures that debtors cannot jeopardize public health and safety through seeking reorganization in bankruptcy. Carlos J. Cuevas, *Bankruptcy Code Section 105(a) Injunctions and State and Local Administrative and Civil Enforcement Proceedings*, 4 AM. BANKR. INST. L. REV. 365, 368 (1996) [hereinafter *Bankruptcy Code Section 105(a)*].

<sup>138</sup> *Chao*, 270 F.3d at 385 (holding that Congress meant the Bankruptcy Code's automatic stay provision to yield to the state and federal governmental interests in “securing compliance with certain aspects of those authorities' respective regulatory and police powers”); *United States v. LTV Steel Co.*, 269 B.R. 576, 581 (W.D. Pa. 2001).

<sup>139</sup> *In re Berg*, 230 F.3d at 1167; *In re Chapman*, 264 B.R. at 569.

<sup>140</sup> 230 F.3d at 1165.

<sup>141</sup> *Id.* at 1167.

<sup>142</sup> *Id.*

<sup>143</sup> See *In re Chapman*, 264 B.R. at 565.

government action against a debtor, the action still falls within the police power exception as long as the deterrent effect of the action protects the government's regulatory interests.<sup>144</sup> The Sixth Circuit Court of Appeals, in *Chao v. Hospital Staffing Services, Inc.*,<sup>145</sup> held the following:

When an action furthers both public and private interests and the private interests do not significantly outweigh the public benefit from enforcement, courts should defer to the legislature's decision to vest enforcement authority in the executive and recognize such actions as within "such governmental unit's police and regulatory power," as that term is used in § 362(b)(4).<sup>146</sup>

These court decisions seem to sidestep the legislative intent to narrowly construe the police power exception and have allowed the courts to find almost all governmental actions fall within the police power exception.<sup>147</sup>

The government can argue that waiting to bring a breach of contract claim against the owner after he emerges from bankruptcy would harm the public health because low income families would become homeless during this period due to limited housing availability.<sup>148</sup> For this reason, an injunction on eliminating the low income housing restriction would be based on the government's police power as in *Village of Bell Terre v. Boraas*.<sup>149</sup> Just as an injunction to enforce zoning restrictions provides all the members of a neighborhood with pleasant housing, an injunction requiring the enforcement of a low income housing restriction provides low income tenants with housing.<sup>150</sup> Since the government would not seek a money judgment against the trustee, the trustee would have difficulty showing that the action for

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<sup>144</sup> See *In re Berg*, 230 F.3d at 1168 (holding that the government can even seek monetary sanctions because monetary penalties can be essential for the government to protect its interests).

<sup>145</sup> 270 F.3d 374 (6th Cir. 2002).

<sup>146</sup> *Id.* at 390.

<sup>147</sup> *Vill. of Bell Terre v. Boraas*, 416 U.S. 1, 9 (1974) (stating the police powers are not limited to powers protecting the public from imminent danger); *Cournoyer v. Town of Lincoln*, 790 F.2d 971, 976 (1st Cir. 1986) (explaining the enforcement of zoning regulations fall within the police power exception); *Penn Terra Ltd. v. Dep't of Env'tl. Res.*, 733 F.2d 267, 273 (3d Cir. 1984) (holding the police powers exception should be construed broadly, and "no unnatural efforts [should] be made to limit its scope"); *In re 1600 Pasadena Offices, Ltd.*, 64 B.R. 192, 194 (Bankr. M.D. Fla. 1986) (recognizing the revocation of a building permit is excepted from the automatic stay because it is not a monetary action).

<sup>148</sup> *Klee & Merola*, *supra* note 137, at 6-7.

<sup>149</sup> 416 U.S. 1, 9 (1974) (holding the police power includes enforcing zoning laws that promote family values and clean air).

<sup>150</sup> *Id.*

injunction would deprive the estate of property.<sup>151</sup> Unfortunately, because all HAP contracts have a limited term, even though the government could enforce the obligations of Section 8 housing for the specified term, the HAP contracts do not ensure availability of low income housing into the future.<sup>152</sup>

### *B. Federally Insured Loans*

Although a bankruptcy trustee may have the power to reject a Section 8 HAP contract as an executory contract,<sup>153</sup> a trustee cannot reject a regulatory agreement accompanying an FHA insured mortgage.<sup>154</sup> When the owner accepts the benefits of federal insurance on his private mortgage, HUD has performed its obligation and the owner cannot avoid the contract responsibilities outlined in the regulatory agreement because it is not an executory contract.<sup>155</sup> Since the trustee cannot reject the obligations under the regulatory agreement between the government and the owner of the property,<sup>156</sup> the trustee must rely on his § 363(f) powers to try to avoid the restriction requiring the owner to use the property for low income housing.<sup>157</sup> The question becomes whether the restrictions documented in the regulatory agreement are the type of property interests that the trustee can strip from the property during a sale.<sup>158</sup>

Congress may have intended the trustee's power as a means to strip property of mortgage liens,<sup>159</sup> but courts have read the language of the statute to mean trustees can sell property free of any interest that is *not* appurtenant to the property if it falls within one of the statutory categories.<sup>160</sup> To determine whether the trustee can sell property free and clear of the low income housing restriction established in the regulatory agreement between the debtor and the

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<sup>151</sup> See 11 U.S.C. § 362(b)(4) (2000).

<sup>152</sup> See *supra* Part I.A.1.

<sup>153</sup> See *supra* Part II.A.

<sup>154</sup> The agreement between the government and the owner is not an executory contract because the government has not substantially performed its obligation to insure the loan. See *supra* text accompanying note 91.

<sup>155</sup> *In re Capital W. Investors*, 186 B.R. 497, 500 (N.D. Cal. 1995). "However expansive the bankruptcy court's power may be to protect the property interests of debtors-in-possession, it does not extend to enlarging the rights of a debtor under a contract or rewriting its terms." *In re EES Lambert Assocs.*, 62 B.R. 328, 336 (Bankr. N.D. Ill. 1986).

<sup>156</sup> See *supra* Part I.A.2.

<sup>157</sup> See *supra* Part I.B.3.

<sup>158</sup> See *supra* Part I.B.3.

<sup>159</sup> See *supra* Part I.B.3.

<sup>160</sup> See *supra* Part I.B.3. A trustee cannot sell property free and clear of an interest that runs with the land or does not meet one of the specifications in § 363(f). 11 U.S.C. § 363 (2000).

government, the court must find any of the following: the restriction is an *in rem* interest that runs with the land; applicable nonbankruptcy law would allow the sale of the property free of the restriction; or the trustee could theoretically compel the holder of the interest to receive monetary satisfaction of the interest.<sup>161</sup> The government has not relied on the argument that a restrictive covenant for low income housing is similar to an access easement, which cannot be separated from a specific piece of property.<sup>162</sup> Rather, the government has argued that applicable state law does not allow the sale of property free and clear of the restriction, and even if state law allowed such a sale, the government cannot be compelled to accept monetary satisfaction.<sup>163</sup>

Courts have clearly held the Bankruptcy Code does not permit such termination if the state has a statute that explicitly prohibits the sale of property free and clear of a certain interest.<sup>164</sup> In *In re 523 East Fifth Street Housing Preservation Development Fund Corp.*,<sup>165</sup> the Bankruptcy Court for the Southern District of New York specifically addressed whether a trustee could sell a piece of property free of a restrictive covenant between the owner and the city of New York limiting the use of the property to low income housing.<sup>166</sup> The court concluded that since the New York statute does not allow an owner of low income housing to bring an action to obtain relief from the restriction when the restriction is created through an agreement between the owner and any governmental unit, § 363(f)(1) does not allow sale of the property free and clear of the low income restriction.<sup>167</sup>

A related issue is whether the government, as the holder of a property interest created by the restrictive use covenant in the regulatory agreement, can be compelled to receive monetary satisfaction of the interest if the property is

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<sup>161</sup> 11 U.S.C. § 363(f). When explaining why a trustee cannot sell property free and clear of an interest, the courts usually combine all three of these categories. See Kuney, *supra* note 100, at 322-23.

<sup>162</sup> See Mattingly, *supra* note 96, at 438. The debate over the sale of property free from restrictive covenants is centered around § 363(f)(5) and not whether the covenant is attached to the land. *Id.*

<sup>163</sup> See *Gouveia v. Tazbir*, 37 F.3d 295, 299 (7th Cir. 1994) (holding that if the owner has the option of receiving equitable relief or monetary relief, the landowner cannot be forced to accept monetary damages).

<sup>164</sup> See *In re Oyster Bay Cove, Ltd.*, 161 B.R. 338 (Bankr. E.D.N.Y. 1993); *In re 523 E. Fifth St. Hous. Pres. Dev. Fund Corp.*, 79 B.R. 568 (Bankr. S.D.N.Y. 1987).

<sup>165</sup> 79 B.R. at 568.

<sup>166</sup> *Id.* at 569-71.

<sup>167</sup> *Id.* at 571-73. Sections 1951-1955 of New York's Real Property Actions and Proceedings Law allows the owner of land restricted to use for charitable, educational, or public purposes to bring an action in state court to obtain relief from the restriction. *Id.* at 571. The landowner, however, does not have this right if the restriction is created between the owner and any governmental unit of the United States or the state of New York. *Id.*

sold free and clear of the covenant. The government has a monetary interest in Section 221(d) housing since HUD insured the project financing.<sup>168</sup> HUD also has a security interest in the regulatory agreement itself.<sup>169</sup> Therefore, the question is whether the property interest created by the restrictive covenant in the regulatory agreement, which requires that the property be used for low income housing, can be reduced to a monetary interest.<sup>170</sup>

One commentator has argued that since a governmental taking of property through eminent domain can reduce any property interest to monetary compensation, a trustee can theoretically sell property free and clear of any interest.<sup>171</sup> Courts have not accepted the breadth of this argument, however, and have prohibited the sale of property free of non-monetary restrictions that run with the land.<sup>172</sup> One justification for this result is explained in Judge Cureton's concurring opinion in *Marathon Finance Co. v. HHC Liquidation Corp.*<sup>173</sup> Judge Cureton recognized that the power to terminate the interest in exchange for compensation does not apply if the holder of the interest has the right to proceed in equity and receive enforcement of the interest rather than money.<sup>174</sup> The Seventh Circuit Court of Appeals explained in *Gouveia v. Tazbir*<sup>175</sup> that even when the holder of a property interest has the option to pursue monetary damages or equitable relief, the debtor could not force the holder of the interest to forego equitable relief.<sup>176</sup> Therefore, the trustee cannot sell the property free and clear of the interest in the absence of a clause in the agreement between the holder of the interest and the debtor that allows the debtor to choose the interest holder's remedy unilaterally.<sup>177</sup>

The trustee's lack of authority to compel receipt of monetary payment for a property interest created by a regulatory agreement is also reflected in the

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<sup>168</sup> See *supra* Part I.A.2. As long as the government's interest is a lien and the property sells for at least the aggregate of the liens on the property, the trustee can sell the property free of the government's lien. 11 U.S.C. § 363(f)(3) (2000).

<sup>169</sup> See *supra* text accompanying note 50.

<sup>170</sup> See *supra* text accompanying note 50.

<sup>171</sup> Mattingly, *supra* note 96, at 452.

<sup>172</sup> *In re Oyster Bay Cove, Ltd.*, 161 B.R. 338, 343 (Bankr. E.D.N.Y. 1993) (holding that the court order to sell the property "free and clear of all liens, claims encumbrances and rights of others of whatever kind or nature" meant interests against the property that could attach to the sales proceeds, not non-monetary restrictions).

<sup>173</sup> 483 S.E.2d 757, 762 (S.C. Ct. App. 1997).

<sup>174</sup> *Id.* at 767.

<sup>175</sup> 37 F.3d 295 (7th Cir. 1994).

<sup>176</sup> *Id.* at 299.

<sup>177</sup> *Id.*

proposition that the government will not receive adequate protection of its interest.<sup>178</sup> HUD's property interest includes the restriction that the property is used for low income housing. Without enforcing the restriction, the government does not have adequate protection for this interest. The court will likely enforce the restriction rather than award a money judgment because HUD has such a right under the regulatory agreement.<sup>179</sup>

Other courts have justified prohibiting the sale of property free and clear of restrictive covenants within regulatory agreements by looking at the characteristics of the restrictive covenant.<sup>180</sup> Judge Felsenthal pointed out, in *In re Welker*,<sup>181</sup> that the debtor agreed to a restrictive covenant in a regulatory agreement in exchange for low cost financing from the government.<sup>182</sup> Rather than merely being a restriction imposed on the buyer, the regulatory agreement is a bargained-for-exchange with the government and the terms of the regulatory agreement should be treated as an enforceable contract.<sup>183</sup> As stated in the Section 8 HAP contract analysis, the owner of the property may choose to breach the regulatory agreement and argue that the government cannot bring an action to enforce the agreement because of the automatic stay.<sup>184</sup> Courts have implied that such actions by the government to enforce restrictions protecting low income housing would not violate the stay as such restrictions are exercised by the government under its police power.<sup>185</sup> The courts have explained that “[t]he Bankruptcy Code does not authorize the court to employ § 363 to supersede or preempt [the] Congressional requirement or the compelling public policy interests behind the housing acts.”<sup>186</sup> A regulatory agreement required by HUD “is not some slight contractual undertaking that

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<sup>178</sup> 11 U.S.C. § 363(e) (2000). The Bankruptcy Code requires that the holder of a secured property interest receive adequate protection upon the sale of the property. *Id.*

<sup>179</sup> Mattingly, *supra* note 96, at 452. Because HUD can choose to proceed in equity to enforce its property right, § 363(f)(5) may not apply. *Id.*

<sup>180</sup> See *supra* text accompanying note 99. Even though restrictive covenants are property interests, the courts acknowledge that they have both contract and property characteristics. See, e.g., *Gouveia*, 37 F.3d at 298.

<sup>181</sup> 163 B.R. 488 (Bankr. N.D. Tex. 1994).

<sup>182</sup> *Id.* at 489.

<sup>183</sup> *Id.*

<sup>184</sup> See *supra* Part I.B.1.

<sup>185</sup> *In re Capital W. Investors*, 186 B.R. 497, 500 (N.D. Cal. 1995). Courts “have emphasized the importance of the federal interest in enforcing [HUD regulatory agreement] terms.” *Id.* A governmental unit does not violate the automatic stay by bringing an action under the unit’s police powers. 11 U.S.C. § 362(b)(4) (2000).

<sup>186</sup> *In re Welker*, 163 B.R. at 489.

can be circumvented by the filing of a bankruptcy petition.”<sup>187</sup> The U.S. Bankruptcy Court for the District of Columbia accepted this view in *In re Clifton Terrace Apartments*<sup>188</sup> by lifting the automatic stay so HUD could exercise its contractual right to take possession of housing the bankrupt debtor failed to keep in good order and repair.<sup>189</sup>

If the trustee attempts to sell the property free of any interest, HUD also has the power to foreclose on the government-insured mortgage.<sup>190</sup> Congress explicitly stated that a foreclosure action by HUD is not a violation of the automatic stay.<sup>191</sup> The foreclosure sale could allow HUD to sell the property to a third party that would continue renting the property to low income families. However, HUD may choose not to foreclose on the property because the foreclosure procedures are time consuming and expensive, as is purchasing the property at the foreclosure sale and maintaining the property.<sup>192</sup>

### C. Low Income Tax Credits and Bankruptcy

Unlike Section 8 housing and government insured loans, the low income housing tax credit for one housing development may be dispersed to the development’s numerous investors.<sup>193</sup> For this reason, if the manager of the development fails to comply with the requirements of the low income housing tax credit agreement, the outside investors face the penalty of having their tax credits recaptured.<sup>194</sup> Rather than having the developer responsible for compliance at the risk of the investors losing their tax credit, most low income housing tax credit developments are operated as a general or limited partnership composed of the developers and the investors.<sup>195</sup> The partnership structure allows the partnership to be treated as an individual taxpayer under the tax code.<sup>196</sup>

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<sup>187</sup> *In re EES Lambert Assocs.*, 62 B.R. 328, 336 (Bankr. N.D. Ill. 1986).

<sup>188</sup> No. 95-1095, 1996 Bankr. LEXIS 852 (Bankr. D.C. May 13, 1996).

<sup>189</sup> *See id.* at \*15. The court lifted the stay because the breach of contract was not only a monetary default, but a “default in providing the type of housing to which the tenants are entitled.” *Id.* at \*14.

<sup>190</sup> *See* 11 U.S.C. § 362(b)(8).

<sup>191</sup> *Id.* For the court to except the action from the stay, the HUD mortgage must be insured under the National Housing Act and the property must have five or more living units. *Id.*

<sup>192</sup> *See, e.g., In re Franklin Park Dev. I*, 64 B.R. 253, 255 (Bankr. D. Mass. 1986) (holding that even with HUD actually managing the housing facilities, the units may be in unacceptable condition to house families).

<sup>193</sup> *See supra* text accompanying notes 65-67.

<sup>194</sup> *See supra* text accompanying note 81.

<sup>195</sup> TAX CREDIT HANDBOOK, *supra* note 61, § 3:219, at 256.

<sup>196</sup> 26 U.S.C. § 42(j)(5)(A) (2000). The Code section only pertains to partnerships that have thirty-five or more partners. *Id.* § 42(j)(5)(B).

If a limited partnership that owns a low income housing development files for bankruptcy, the partnership wants to maximize the value of its estate by retaining or selling the property with limited restrictions. Due to the extended low income housing commitment, the property is encumbered at the very least by occupancy and rent restrictions.<sup>197</sup> The bankruptcy trustee may argue that he can sell the property free of these restrictions under § 363(f) of the Bankruptcy Code, but as stated in the federally insured mortgage section, courts are reluctant to allow trustees to strip covenants that run with the land from the property.<sup>198</sup> The problem arises when the owners try to retain the property and refuse to comply with the restrictions. While a recorded restrictive covenant gives the tenants and PHA the right to sue the owner for noncompliance with the covenants,<sup>199</sup> the automatic stay may prohibit such actions.<sup>200</sup> To maintain a claim against the owner, the tenant or PHA must show that the claim falls within an exception to the automatic stay or justifies relief from the stay.<sup>201</sup>

The PHA have a good argument that enforcing the restrictive covenants within the extended low income housing commitment is a proper use of the government's police power.<sup>202</sup> The PHA are seeking preservation of low income housing, not monetary satisfaction. Through the courts' broad reading of the police power exception, the government's action to enforce the restrictive covenants satisfies both the pecuniary purpose test and the public policy test.<sup>203</sup> The PHA can easily argue that preserving low income housing effectuates public policy rather than adjudicating private rights.<sup>204</sup>

The housing authority or the tenant may also bring a claim for enforcement of the restrictions by seeking relief from the automatic stay.<sup>205</sup> The court will grant relief from the stay if the party shows grounds for relief.<sup>206</sup> The PHA never received a security interest in the owner's property to protect the government's interest in the low income housing. Therefore, the PHA cannot

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<sup>197</sup> See *supra* text accompanying notes 70-73.

<sup>198</sup> See, e.g., *Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994); *In re Oyster Bay Cove, Ltd.*, 161 B.R. 338 (Bankr. E.D.N.Y. 1993); *In re 523 E. Fifth St. Hous. Pres. Dev. Fund Corp.*, 79 B.R. 568 (Bankr. S.D.N.Y. 1987).

<sup>199</sup> 26 U.S.C. § 42(h)(6)(B)(ii).

<sup>200</sup> See *supra* Part I.B.1.

<sup>201</sup> See *supra* Part I.B.1.

<sup>202</sup> See 11 U.S.C. § 362(b)(4) (2000).

<sup>203</sup> See *supra* text accompanying notes 139-43.

<sup>204</sup> *Berg v. Good Samaritan Hosp. (In re Berg)*, 230 F.3d 1165, 1167 (9th Cir. 2000).

<sup>205</sup> 11 U.S.C. § 362(d)(1).

<sup>206</sup> See *id.*; see also *supra* note 89.

show lack of adequate protection or necessity of a security interest.<sup>207</sup> For unsecured creditors, courts use a totality of the circumstances test on a case by case basis to determine whether the creditor has established cause<sup>208</sup> and usually grant relief from the stay when at least one of two factors is present: the debtor engaged in a morally culpable action which the creditor wants to undo through a court action, or the creditor is not seeking to pursue assets of the estate, but seeks relief through other remedies.<sup>209</sup> Because the PHA and the tenant are seeking enforcement of the restrictive covenants and not a monetary judgment, the court would likely grant relief.

If the court is unable to police the owners after ordering compliance with the restrictions, the IRS can argue that bringing a recapturing action is within its police power.<sup>210</sup> Moreover, the IRS can argue that the government is bringing the action to recapture the tax credit as a way to deter partnerships who receive the low income tax credit from filing bankruptcy as a way to avoid penalties for ceasing to rent the property to low income families.<sup>211</sup> By just seeking a money judgment for breach of the agreement to provide low income housing, the IRS is using its regulatory powers to effectively deter taxpayers from violating tax regulations.<sup>212</sup> The courts recognize that “[w]hen the government seeks to impose financial liability on a party, it is plainly acting in its police or regulatory capacity [by] attempting to curb certain behavior . . . by making the behavior that much more expensive.”<sup>213</sup> Therefore, bringing an action to gain a money judgment is within the regulatory powers, but the automatic stay prohibits anything beyond the entry of a judgment.<sup>214</sup> However, the recapturing action will not itself force the debtor to continue to use the property as low income housing for several reasons. First, the recapturing action does not serve to force the owner to lease to low income families—it is merely an action to recollect the tax credit.<sup>215</sup>

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<sup>207</sup> See *supra* Part I.A.3.

<sup>208</sup> *Busch v. Busch (In re Busch)*, 294 B.R. 137, 140 (B.A.P. 10th Cir. 2003). The creditor has the burden to show cause, but the burden then shifts to allow the debtor to demonstrate why the court should not lift the stay. *Id.* at 140-41.

<sup>209</sup> *In re Stranahan Gear Co.*, 67 B.R. 834, 837 (Bankr. E.D. Pa. 1986). A creditor may seek an injunction or declaratory judgment as a way to protect his interests. *Id.*

<sup>210</sup> See *supra* text accompanying note 88.

<sup>211</sup> See *SEC v. Brennan*, 230 F.3d 65, 72 (2d Cir. 2000).

<sup>212</sup> See *City of New York v. Exxon Corp.*, 932 F.2d 1020, 1024 (2d Cir. 1991) (holding that bringing an action for entry of a money judgment is a direct exercise of police power by providing an effective deterrent to those who violate government regulations).

<sup>213</sup> *Brennan*, 230 F.3d at 72.

<sup>214</sup> *Id.* at 71.

<sup>215</sup> See *supra* text accompanying note 81.

Second, and more significantly, the recapturing action is likely to have little effect on its own because any subsequent action the IRS takes to enforce the judgment from the recapturing action would constitute a violation of the automatic stay.<sup>216</sup>

The IRS may try to bring an action to enforce the monetary judgment by seeking relief from the stay.<sup>217</sup> The only way the court will grant relief to recapture the tax credits is if the IRS proves there is good cause to grant relief.<sup>218</sup> Because the IRS would in fact be collecting assets from the estate,<sup>219</sup> the IRS would have to stress the immorality of the owner-debtor's behavior. The IRS would have to show that each recipient of the low income housing tax credit who files for bankruptcy is doing so as a way to avoid renting property to low income families below the market rate.

### III. HOW THE VOICES OF THE TENANTS CAN BE HEARD NOW

The government has tried to implement programs that will ensure accessible housing for low income families for years. While the programs Congress created are not perfect, they have housed many families who would otherwise lack safe, decent, affordable housing. To protect these families from losing their homes due to the owners filing bankruptcy, the bankruptcy courts should simply alter their interpretation of the Bankruptcy Code.

#### A. *Proposed Changes to Protect Section 8 Tenants*

Since Section 8 housing projects are regulated primarily through contract law, courts should adopt a new test for approving the rejection of a HAP contract. The test proposed by the Fifth Circuit Court of Appeals in *In re Mirant Corp.*<sup>220</sup> would allow courts to disapprove of a trustee rejecting a HAP

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<sup>216</sup> See *supra* Part I.B.1.

<sup>217</sup> 11 U.S.C. § 362(d)(1) (2000).

<sup>218</sup> See *supra* text accompanying note 89; see also 11 U.S.C. § 362(d)(1).

<sup>219</sup> H.R. REP. NO. 95-595, at 3367 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6323. Congress intended the scope of interests that are property of the estate to be broad and included the right to a tax refund as property of the estate. *Id.* Since a low income housing tax credit is in essence a tax refund, the credits the owner claims during the compliance period prior to the owner filing for bankruptcy are part of the owner's bankruptcy estate. See TAX CREDIT HANDBOOK, *supra* note 61, at 1 (a tax credit offsets an individual's taxes dollar for dollar rather than serving as a deduction).

<sup>220</sup> Official Comm. of Unsecured Creditors of Mirant Corp. v. Potomac Elec. Power Co. (*In re Mirant Corp.*), 378 F.3d 511, 525 (5th Cir. 2004).

contract.<sup>221</sup> Unlike the business judgment rule standard,<sup>222</sup> this test requires the court to balance the benefits to the bankruptcy estate with the burdens imposed on the non-debtor parties due to the rejection of the contract.<sup>223</sup> In such analysis, courts would weigh the benefit to the estate of earning more money by renting to a family that is not classified as low income against the burden to the recent tenants of losing their housing, and the burden to HUD of losing a low income housing facility. In theory, the bankruptcy court would be weighing the objective of chapter 11 bankruptcy—permitting the successful rehabilitation of the debtor while maximizing the value of the bankruptcy estate—against the objective of the National Housing Act—providing a decent home and suitable living environment for every family.<sup>224</sup> Since neither statute has priority over the other,<sup>225</sup> the court would have discretion to find that the burden to the public health outweighs the benefit to the debtor's estate.<sup>226</sup>

The stricter test would be extremely beneficial because the new construction HAP contracts are enforceable for up to forty years.<sup>227</sup> By implementing the stricter test, courts could require trustees to assume contracts that specify the debtor's property will remain low income housing for an extended period. The government would no longer have to prove that the long-term HAP contract is *not* an executory contract and therefore an enforceable obligation.<sup>228</sup> Courts cannot wait for Congress to amend the Bankruptcy Code to forbid the bankruptcy trustee from rejecting HAP contracts; Congress has already illustrated its unwillingness to lessen the trustee's power when it changed the test for approving the rejection of an executory contract from a business judgment rule standard to a balancing test.<sup>229</sup>

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<sup>221</sup> *See id.*

<sup>222</sup> *See supra* text accompanying notes 128-29.

<sup>223</sup> *See supra* text accompanying notes 130-32.

<sup>224</sup> *In re Capital W. Investors*, 186 B.R. 497, 499-500 (N.D. Cal. 1995).

<sup>225</sup> *In re Welker*, 163 B.R. 488, 489 (Bankr. N.D. Tex. 1994).

<sup>226</sup> *Mirant*, 378 F.3d at 525. Under the stricter test, the court could only approve rejection if the equities balance in favor of rejection. *Id.*

<sup>227</sup> *See supra* text accompanying note 32.

<sup>228</sup> *See supra* Part II.A.

<sup>229</sup> *See supra* note 131.

*B. Changes to Protect Tenants of Low Income Housing Projects Financed Through Government Insured Loans*

Bankruptcy courts can protect tenants living in Section 221(d) housing by limiting the definition of the property rights included in § 363(f) to mortgage liens like Congress had intended.<sup>230</sup> Doing so would prevent trustees from selling the property free of the low income restrictions recorded in the regulatory agreement. Additionally, a clear definition would terminate the confusion surrounding whether applicable nonbankruptcy law would allow the sale of the property free of a property interest or if the holder of the interest could be satisfied with monetary compensation.<sup>231</sup> Since a regulatory agreement is not enforceable if the federally insured mortgage is no longer valid, however, if a trustee can sell the property free of the mortgage lien, the regulatory agreement is also terminated.<sup>232</sup> For this reason, the courts also need to view the regulatory agreement as a recorded restrictive covenant that is separate from the recorded mortgage.

*C. Changes to Protect Tenants of Low Income Housing Benefiting from the Low Income Housing Tax Credit*

Preserving low income housing owned by an individual who receives the low income housing tax credit and is facing bankruptcy is not difficult because the occupancy and rent restrictions are recorded in the county records.<sup>233</sup> To ensure the owners continue to abide by the restrictions after filing bankruptcy, the courts must create an enforcement mechanism. First, the courts should allow housing authorities and tenants to bring claims to enforce the restrictive covenants pursuant to the police power exception.<sup>234</sup> Second, courts should allow the IRS to recapture the tax credit under the police power exception as a means of encouraging compliance with the restrictive covenants rather than requiring the courts to police enforcement.<sup>235</sup>

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<sup>230</sup> See *supra* note 97 and accompanying text.

<sup>231</sup> 11 U.S.C. § 363(f) (2000).

<sup>232</sup> See *supra* text accompanying notes 53-54.

<sup>233</sup> See *supra* Part I.A.3.

<sup>234</sup> See *supra* text accompanying notes 202-04.

<sup>235</sup> See *supra* text accompanying note 81.

#### IV. HOW THE VOICES OF THE TENANTS CAN BE HEARD IN THE FUTURE

To ensure that the voices of the tenants are heard in the future, the government agencies responsible for running the low income housing programs must carefully draft the agreements that create the affordability restrictions.<sup>236</sup> Through specifically defining the affordability requirement within the regulatory agreement as a restrictive covenant, courts could prohibit trustees from selling Section 221(d) housing free from the covenant.<sup>237</sup> The IRS could accomplish the same by requiring the recipient of the low income housing tax credit to sign a contract providing the IRS with a security interest in the property.

##### A. *Changes to the Section 221(d) Regulatory Agreement*

The problem HUD faces with FHA-insured loans to owners of low income housing is that the trustee may seek to sell the property free and clear of the low income housing restriction.<sup>238</sup> Congress has addressed this problem by requiring owners to get HUD's permission before selling governmentally insured property,<sup>239</sup> but to avoid having owners litigate to force HUD to give such permission, HUD could address the problem by clearly drafting the regulatory agreements. To accomplish this goal, HUD should include terms in the regulatory agreement that prohibit a bankruptcy trustee from selling the property free and clear of the low income housing restriction. Since almost every jurisdiction has a property law provision stating that courts will only find restrictive covenants unenforceable when there are changed conditions,<sup>240</sup> HUD could include a clause stating that filing for bankruptcy does not constitute a change in conditions and therefore, does not entitle the owner to sell the property free of restrictive covenants. With this restriction, the trustee could not sell the property under § 363(f)(1) because applicable nonbankruptcy law does not allow sale of the property free and clear.<sup>241</sup>

An additional option is for the regulatory agreement to include a term that permits the government to seek equitable relief for default of a governmentally

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<sup>236</sup> Because the Section 8 Voucher Program consists of short-term contracts, and the Section 8 New Construction Program no longer exists, the following section suggests changes to Section 221(d) housing regulatory agreements and Low Income Housing Tax Credit agreements.

<sup>237</sup> See *supra* text accompanying note 162.

<sup>238</sup> See *supra* Part I.B.3.

<sup>239</sup> See *supra* text accompanying notes 55-56.

<sup>240</sup> Mattingly, *supra* note 96.

<sup>241</sup> 11 U.S.C. § 363(f)(1) (2000).

insured mortgage. This will prevent some trustees from trying to sell the property free and clear pursuant to § 363(f)(5) which allows the sale if a monetary judgment is sufficient.<sup>242</sup> Even with this provision, some trustees will bring litigation based on the theory that if the government can provide monetary satisfaction for eminent domain, a money judgment is theoretically sufficient.<sup>243</sup> Nevertheless, since most courts have not accepted this argument, the provision will help protect low income housing.<sup>244</sup>

### *B. Changes to the Extended Low Income Housing Commitment*

As the extended low income housing commitment ensures that the occupancy and rent restrictions remain on the property post bankruptcy,<sup>245</sup> the PHA that draft the commitments must find a way to force the owners to abide by the commitment during bankruptcy. One way to accomplish this is to include a term within the commitment that gives the PHA a security interest in the housing complex. The PHA could require a lien on the property in exchange for the allocation of the tax credit. Doing so gives the PHA a security interest in the property that is entitled to adequate protection upon the owner filing bankruptcy.<sup>246</sup> Thus, the PHA could argue to the bankruptcy court that its security interest is not adequately protected unless the housing is available to low income families.

## CONCLUSION

Protecting tenants of low income housing projects from the consequences of housing complex owners filing for bankruptcy requires the courts to confront two different statutory schemes and “attempt to harmonize the goals and policies of each.”<sup>247</sup> The courts look to the Bankruptcy Code for direction on how to provide the debtor with a fresh start and the Housing Acts for direction on how to provide every family with a home.<sup>248</sup> To ensure that these two schemes do not conflict, bankruptcy courts must interpret the Bankruptcy Code in a way that forces the owners to abide by the low income housing

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<sup>242</sup> *Id.* § 363(f)(5).

<sup>243</sup> *See supra* text accompanying note 171.

<sup>244</sup> *See supra* text accompanying note 172.

<sup>245</sup> *See supra* text accompanying notes 197-98.

<sup>246</sup> *See supra* note 178 and accompanying text.

<sup>247</sup> *In re Capital W. Investors*, 186 B.R. 497, 499 (N.D. Cal. 1995).

<sup>248</sup> *See id.*

regulations within the HUD and IRS agreements.<sup>249</sup> Additionally, government agencies must meticulously draft these contracts to leave very little ambiguity as to what interests the government holds in the property and what interest the owner of the property can contribute to the bankruptcy estate.<sup>250</sup>

The problem of owners of low income housing filing for bankruptcy may not lead to an immediate catastrophe, but as the owners begin to make money and realize they can make even more money from renting to wealthier tenants, the owners will look into mechanisms to avoid the restrictions imposed by the government. These owners will soon discover the loopholes in the Bankruptcy Code and their contracts, and Congress will have little time to prevent the low income families from becoming homeless. By addressing this problem now, Congress could create a stronger and more stable low income housing structure without harming the goals of the Bankruptcy Code, allowing the voices of the tenants to be heard.

SHERYL A. KASS\*

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<sup>249</sup> Congress must expressly state that HUD actions are exceptions to the automatic stay since they fall under HUD's regulatory powers and that a Low Income Affordability Restriction is a restrictive covenant that cannot be stripped from the property under § 363(f).

<sup>250</sup> HUD has bargaining power as to what obligations are placed in the regulatory agreement and the Bankruptcy Code respects the freedom of contract. See 12 U.S.C. § 1715z-1(e)(1) (2000) (allowing Secretary of HUD to set requirement of housing); *In re EES Lambert Assocs.*, 62 B.R. 328, 336 (Bankr. N.D. Ill. 1986) (holding that the Bankruptcy Code cannot circumvent a HUD regulatory agreement).

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