

**DEALING WITH BANKRUPTCIES,  
FORECLOSURES AND RECEIVERSHIPS**

*By:*

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## **DEALING WITH BANKRUPTCIES, FORECLOSURES AND RECEIVERSHIPS**

### **I. INTRODUCTION**

Bankruptcy, foreclosure and receiverships involving properties with code violations are a common challenge confronting code enforcement officers, particularly in the current economy. The code officer has to determine the responsible party to remedy the violation, and, if that person will not do so voluntarily, the appropriate enforcement mechanism. It is the intent of this paper to discuss the legal background of bankruptcy, foreclosure and receiverships, and to assist the code enforcement officer in resolving violations that present these issues.

### **II. BANKRUPTCY**

Bankruptcy is a legally declared inability to pay creditors. In the vast majority of cases, bankruptcy is initiated by the debtor in order to obtain relief from creditors. However, creditors may file a bankruptcy petition against a debtor to recoup what they are owed. Each U.S. Federal District Court handles bankruptcy matters, and in almost all districts, bankruptcy cases are filed in the bankruptcy court. Bankruptcy is a matter of federal law and cases cannot be filed in state courts.

Chapter 7 bankruptcy (also called a liquidation bankruptcy) is the most common type of bankruptcy filing.<sup>1</sup> An impartial trustee is appointed by the bankruptcy court,

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<sup>1</sup> 11 U.S.C. § 701 et seq.

usually an attorney. The primary role of the trustee is to sell the debtor's nonexempt assets to maximize the amount for unsecured creditors. Under Chapter 7, an individual may be able to keep certain exempt property, such as the primary residence.<sup>2</sup> All other assets are sold or distributed to the creditors. A corporation or partnership may also file Chapter 7 bankruptcy in which case the assets are distributed to creditors and the entity is dissolved.

A Chapter 11 bankruptcy permits reorganization and is most prominently used by corporate entities. In most instances the debtor remains in control of her business operations as a “debtor in possession,” and is subject to the oversight and jurisdiction of the court.<sup>3</sup> Unlike the appointed trustees for Chapters 7 and 13, Chapter 11 of the bankruptcy code places the debtor in possession in the position of a fiduciary for the creditors, with the rights and powers of a trustee.<sup>4</sup> A special U.S. trustee is responsible for monitoring the debtor in possession's operation of the business.

Under a Chapter 13 bankruptcy, the debtor proposes a plan to pay certain creditors over a 3- to 5-year period based on a detailed written plan.<sup>5</sup> There are certain advantages of a Chapter 13 over a Chapter 7 including stopping a foreclosure, at least temporarily, and the debtor generally gets to retain his or her property. Also, more of the debts are dischargeable. A trustee is also appointed in Chapter 13 bankruptcies. A

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<sup>2</sup> 11 U.S.C. § 522.

<sup>3</sup> 11 U.S.C. § 1101 et seq.

<sup>4</sup> 11 U.S.C. § 1107.

<sup>5</sup> 11 U.S.C. § 1301 et seq.

Chapter 13 trustee reviews the debtor's payment plan and collects and distributes those payments.

A bankruptcy discharge relieves the debtor of personal liability for certain debts. On the other hand, the debtor's property (unless it is subject to an exemption) is sold to pay off creditors. Creditors can be further broken down into secured creditors and unsecured. A claim or debt is unsecured if there is no collateral that is security for the debt. Most consumer debts are unsecured. The unsecured creditors receive the proceeds from the sale of the debtor's property. These creditors may receive pennies on the dollar or nothing. However, a secured creditor with a lien on property may enforce the lien to recover the property. A claim secured by a lien is "secured" at least up to the value of the collateral property. Generally, a secured claim must be perfected which means a lien or security interest must be recorded in the public records. A mortgage, line of credit and a car loan are the most common types of secured debts.

Further, an item of property subject to a valid lien will not be sold to repay other creditors. Certain property is exempt from being distributed via the bankruptcy including some portion of the debtor's residence and vehicle.<sup>6</sup> Other exemptions include some portion of the debtor's primary vehicle and the debtor's "tools of the trade" or his means of occupation.

A bankruptcy petition, upon the moment of filing, operates as an automatic stay. The automatic stay halts actions by creditors, with certain exceptions, to collect debts

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<sup>6</sup> See 11 U.S.C. § 522.

from a debtor who has declared bankruptcy.<sup>7</sup> A stay also generally prohibits the commencement of actions and enforcement of judgments against the debtor and the estate of the debtor. The stay is very important as violation of the stay could result in contempt of court.

The U.S. Bankruptcy Code provides an exception for functions involving the governmental police powers.<sup>8</sup> That code states that the filing of a bankruptcy petition does not operate as a stay upon

the commencement or continuation of an action or proceeding by a governmental unit ..., to enforce such governmental unit's or organization's police and regulatory power, including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental unit's or organization's police or regulatory power.  
The bankruptcy filing will not prevent uniform enforcement of the law.

In other words, an officer need not refrain from issuing and prosecuting a citation for a code violation even though the property owner is in undergoing bankruptcy.

In In re Douglas S. Nease and Brenda M. Nease,<sup>9</sup> the county zoning enforcement office issued a citation to a homeowner for excessively tall grass. The homeowner had already filed a Chapter 13 bankruptcy petition and had prepared a repayment plan surrendering the house to the mortgage company. However, the mortgage company had not taken any action to reclaim the house. The debtor first sent a “cease and desist” letter to zoning enforcement stating that the debtor could not be liable for the code

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<sup>7</sup> Section 362 of the United States Bankruptcy Code, 11 U.S.C. § 362.

<sup>8</sup> 11 U.S.C.A. § 362(a), (b)(4).

<sup>9</sup> 391 B.R. 470 (2008).

violations. In response to the letter, the zoning enforcement pursued its citation. The debtor then filed for a motion for sanctions against the county for violating the stay. The bankruptcy court said that this was a clear instance of a county enforcing its laws under its police powers.

Courts often use the “pecuniary purpose test” for determining whether action by a governmental unit is prohibited by the automatic stay or is excepted under police power exception. Under this test, the court asks whether the governmental proceeding, such as a code enforcement proceeding, relates primarily to protection of the government's financial interest in the debtor's property or to matters of public safety and health. If the concern is a matter of public safety or health, the proceedings are provided for in the exception to the stay.<sup>10</sup> Actions to enforce county and city codes involving such instances as dangerous structures or tall grass will almost always satisfy the test as a promotion of public health and safety. Situations that fail the test are usually in other categories. For instance, a court may find that governmental regulation of a grain elevator was intended to protect the financial interests of farmers as opposed to the health and safety of the public.<sup>11</sup> Likewise, where a local government attempted to suspend a chiropractor's license, the bankruptcy court found this was based solely upon non-payment of taxes and the exemption to the stay did not apply.<sup>12</sup>

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<sup>10</sup> 11 U.S.C.A. § 362(a), (b)(4); In re Smith-Goodson, 144 B.R. 72 (Bankr. S.D. Ohio 1992).

<sup>11</sup> In re Cox Cotton, 647 F.2d 768 (8th Cir. 1981), *cert. denied*, 454 U.S. 1162 (1982).

<sup>12</sup> In re North, 120 B.R. 592 (Bankr. D. Vt. 1991).

Although it may be technically permissible, the bankruptcy court will often not allow the imposition of fines on the debtor. Rather, the county or city can place a lien on the property or, potentially, condemn the property under its police power.<sup>13</sup>

### **III. FORECLOSURE**

Foreclosure is the proceeding in which a mortgagee, or other lienholder, usually a lender, obtains a mortgagor's equitable right of redemption. This right of redemption is the legal right by the borrower (often a homeowner) to pay the outstanding mortgage debt on the property and thereby redeem her property prior to the foreclosure sale.

A foreclosure may be by court order, but in Georgia, it is usually done through a power of sale provision in the mortgage or security deed. When a home is foreclosed the lender is not the owner. A foreclosure is merely a forced sale by the homeowner. The real property changes hands after the tender of the bid amount by the high bidder at the foreclosure sale. At that point, the debtor's interest in the property terminates.<sup>14</sup> From then on, the purchaser at a foreclosure sale under a power of sale in a security deed is the sole owner of the property until and unless the sale is set aside.<sup>15</sup> Prior to that time, the homeowner listed on the warranty deed remains the owner. In many, if not most cases, the bank or lender owning the security interest is the purchaser of the property at the public sale. Often, property owners will attempt to use foreclosure as an excuse

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<sup>13</sup> See In re Douglas S. Nease and Brenda M. Nease, 391 B.R. 470 (2008).

<sup>14</sup> Champs-Elysses, Inc. v. Fulton Federal Sav. & Loan Ass'n, 247 Ga. 127, 274 (1981).

<sup>15</sup> Bellamy v. F.D.I.C., 236 Ga.App. 747 (1999).

from correcting violations on their property. These owners will sometimes move away from the property with the expectation that the bank or secured party will take over responsibility. However, the bank or whichever party may have the right to foreclose may well take its time. The property is still the responsibility of the homeowner even if that person has moved away from the property and attempted to wash his hands of it. Further, fines that are imposed for actions of an owner prior to a foreclosure sale can be pursued even after the foreclosure sale. In other words, an officer need not refrain from issuance and prosecution of a citation even though the property owner is subject to foreclosure.

A lis pendens is a written notice filed in the property records where the land lies showing that a suit has been filed involving the property. The lis pendens notice thus subjects the property to whatever claim has been made by the suit. The lis pendens may be recorded in a different county than the suit that it records as a defendant is typically sued in his or her county of residence (not where the land lies). The purpose of a lis pendens is to notify any potential purchaser of property that the property is involved in a pending lawsuit which seeks some relief respecting that particular property.<sup>16</sup> The most typical use of a lis pendens is when someone claims an interest in property contrary to the person having possession of the property. Lis pendens are also properly filed in cases where a party seeks to have equitable relief requiring acts to be performed on the property (such as cleaning up a code violation).

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<sup>16</sup> Boca Petroco, Inc. v. Petroleum Realty II, LLC, 2008 WL 2312928 (2008).

While the lis pendens may have the practical effect of hampering the marketability of a property, it does not prevent someone else from purchasing the property if that person is willing to take the risk as to the results of the suit.<sup>17</sup> Also, the lis pendens does nothing to “protect” the property from enforcement violations. A lis pendens must be released either by the termination of the lawsuit (including the appeal), by order of the court or by dismissal by the one who filed it.

Since most Georgia foreclosures are based on the power of sale, and take place outside of court proceedings, it can sometimes be difficult to determine who is in possession of the real property. The foreclosing party is usually that listed in the security deed filed in the county land records. However, banks and lenders often assign the secured interest to other banks and lenders. These “assignments” should also be recorded in the county land records but sometimes are not. A convenient place for looking up deeds and assignments is the website of the Georgia Superior Court clerks, WWW.GSCCCA.ORG. Records for 1993 onward from all counties in Georgia can be viewed there and are usually up to date within a few weeks.

Lien interests in real property are accorded priority according to the chronological sequence of creation, i.e. an older lien is senior to a more recent (junior) lien. In other words, foreclosing on a senior lien wipes out junior liens (tax liens excluded).<sup>18</sup> However, a junior lienholder has a claim on any funds received at the

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<sup>17</sup> Dodge v. Clark, 268 F. 784 (5<sup>th</sup> Cir. 1920).

<sup>18</sup> O.C.G.A. § 44-14-530(b).

foreclosure sale if anything is left after satisfying older liens.<sup>19</sup> From a code enforcement standpoint, the time when the lien is obtained is the determinative factor. A lien for nuisance abatement is subordinate to liens filed prior to that lien. Thus, if an older lien is foreclosed upon, the purchaser of the property takes it free and clear of the code enforcement lien.<sup>20</sup> However, the purchaser may still be required to fix any continuing violations.

#### **IV. RECEIVERSHIP**

A receiver is appointed by the court when there is property having no one to manage it or when property is in litigation and the rights of the parties cannot be protected without the appointment of a receiver.<sup>21</sup> Court-appointed receivers have the powers granted them by the court and oftentimes have complete control over the property as if the receiver is the owner. The receiver can borrow money, contract with repair personnel and contractors, collect rents and relocate tenants. In other cases, the receiver has much more limited powers as when a receiver is appointed only to sell a property. The name of the receiver can be found in the court order appointing her in the clerk of court's file.

A receiver can be sued or cited in her official capacity for negligence in maintenance of the property but not in her personal capacity.<sup>22</sup> Thus, a receiver could

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<sup>19</sup> Cook v. Farmers and Merchants Bank, 247 Ga. 661 (1981).

<sup>20</sup> O.C.G.A. § 44-14-530.

<sup>21</sup> O.C.G.A. § 9-8-1.

<sup>22</sup> Becknell v. McConnell, 142 Ga.App. 567 (1977).

potentially be cited for code violations in addition to the property owner, and there would be nothing improper with this. This would be the case if the receiver was the party actually causing or allowing the code violation.<sup>23</sup> However, the consent of the court must be obtained prior to adding the receiver as a party to an action.<sup>24</sup> This action must be brought in the superior court of the county in which the property owner resides.<sup>25</sup> Even with a receiver, it is still proper to bring an action against the property owner. This is the better practice when issuing a citation. However, if injunctive relief is sought, such as remedying a nuisance, it may be necessary to seek the court's permission to bring suit against the receiver as well as the property owner. After all, the receiver is the party in control of the property and most likely to correct issues on the property.

Many cities throughout the country have set up receivership programs through their code enforcement. Under these programs, when a property has significant code violations and the property owner is unwilling or unable to resolve them, the county or city can ask the court to appoint a receiver and take temporary possession of the property in order to abate the code violations. Other interested parties holding a lien or security in the property are notified and offered the chance to correct the violations. Cooperative lienholders can then seek reimbursement from the property owner. If there is no cooperation from the lienholders and owner, the local government corrects the

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<sup>23</sup> See Becknell v. McConnell, 142 Ga. App. 567 (1977).

<sup>24</sup> Id.

<sup>25</sup> O.C.G.A. § 9-8-1.

violations, and the owner or lienholders are responsible for all costs. If costs are not then recovered from the owner, the local government will file a petition with the court to sell the property to recover costs. The proceeds from the sale of property go first to satisfy the cost of correction before paying any other lienholders.