WHAT TO EXPECT WHEN FILING BANKRUPTCY

A little over a hundred years ago, Supreme Court Justice John Clark McReynolds wrote that the purpose of the Bankruptcy Code is "to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." The law has changed several times, most recently in 2005, but that overriding principle, to give the honest but unfortunate debtor a fresh start, remains in place.

To accomplish this goal, bankruptcy essentially allows debtors to eliminate many debts and make catch-up payments on other ones. Although it is a powerful tool, bankruptcy is also one of the most misunderstood federal court procedures. Most people have some idea what to expect in civil and criminal cases, but bankruptcy is a mystery to most. As a result, there are many myths about what happens to people who file voluntary petitions.

Most people have played Monopoly or similar board games at one time or another. In Monopoly, if players run out of money, they must declare bankruptcy. They lose all their property and have no chance to re-enter the game. Fortunately, life is not like Monopoly, at least in this respect. The purpose of this publication is to give debtors a better idea of what to expect between the time they file their voluntary petitions and they receive their discharge orders.

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WHAT HAPPENS TO ASSETS IN BANKRUPTCY?

In Monopoly bankruptcies, players lose all their property. That's because the B&O Railroad and the houses on Park Place and the unimproved lot on Ventnor Avenue are not personal property. In a real-life bankruptcy, almost all personal property is exempt from seizure, so debtors get to keep it with no added strings attached.

The Bankruptcy Code has a list of exempt property that basically serves as a model for state laws. In some states, debtors can apply these federal exemptions to their property; in other states, debtors must use the ones provided under state law.

There is an important caveat. If the property has a loan against it, the owner must continue making payments according to the agreed-upon terms, because secured moneylenders do not care if their current customers file bankruptcy or not. If the payments stop, they will ask the judge for permission to go around the automatic stay and repossess the property, and judges nearly always grant special permission in these cases.

HOUSE

The law varies by jurisdiction, but most states allow debtors to keep their homes if they do not have more than a certain amount of equity; that amount is typically between $25,000 and $50,000. Unless they have been in their homes for more than eight or ten years, most people do not have more equity than that in their homes. And, quite frankly, homeowners with large amounts of home equity probably do not need to file bankruptcy to eliminate their debts.

Debtors list their houses, and any other similar assets, on Schedule A. In addition to the property, debtors must also declare a value. This is where it gets a little tricky, because the value that the county tax assessor uses is generally not the same as the home's fair market value. Tax appraiser values are often slightly inflated, so the taxing jurisdictions obtain a little more revenue.

Moreover, according to the Bankruptcy Code, debtors must list their assets' "garage sale value." So, the question is not so much fair market value, but how much the house would be worth in a non-inspection, as-is cash sale. Most home investors will not pay more than 60 percent of fair market value in such transactions, and their initial offers are typically much lower than that. If there are issues with the amount of equity, this fact could well come into play.

Assume Dora Debtor owns a house that is valued at $200,000 on the tax appraiser's website and her loan balance is $150,000. At first blush, she appears to have $50,000 in home equity and therefore, depending on where she resides and whether she uses federal or state exemptions, Dora may run afoul of the equity limit. But the $200,000 figure on the website is not the fair market value, and it is also not the as-is cash sale value. In fact, the "garage sale" value is arguably $120,000, because that is what a home investor would pay Dora for the house. So, although she may have $50,000 after a list sale, she might be saddled with $30,000 of negative equity in an as-is cash sale.

Debtors should be very careful when listing the value of assets, because substantially under-valuing them means a red flag to the trustee at best and a bankruptcy fraud prosecution at worst. Fortunately, experienced bankruptcy attorneys know both the applicable law and the informal procedural rules in a given jurisdiction, so these professionals are well-suited to give solid advice.

RETIREMENT ACCOUNTS

In many households, a 401(k), IRA, or other retirement savings plan is the family's largest asset. The Bankruptcy Code expressly states that these accounts are exempt, and the United States Supreme Court recently reaffirmed this principle in Clark v. Rameker (2014). That case involved a debtor who inherited a $450,000 IRA from her mother; by the time the heir filed Chapter 7 bankruptcy, the account balance was about $300,000, because unless the new owner was the original owner's spouse, monthly payments are the only disbursement option in inherited IRAs.

Writing for a unanimous Court, Justice Sonia Sotomayor observed that since the Bankruptcy Code did not define "retirement account," the Court must use the phrase's ordinary meaning. Simply stated, retirement accounts consist of funds that the owners set asides during their working careers so they would have money for retirement. Because the debtor in this case made no contributions to the account, and also because inherited IRAs are different from other types of IRAs in several ways, the Court reasoned that an inherited IRA is not a "retirement account" within the confines of the Bankruptcy Code.

Although Clark went against the debtor, the holding applies only in the handful of cases that involve inherited IRAs. The important thing is that the Supreme Court accepted the Bankruptcy Code as gospel truth on this issue, and reaffirmed that these accounts are 100 percent exempt in most cases, even if the balance is several hundred thousand dollars.

There is a related issue as well. While defined contribution plans, like IRAs, have ascertainable values, defined benefit plans, like company pensions, are essentially worthless unless and until the account owner retires.

NON-EXEMPT ASSETS

In addition to a primary residence and a retirement account, most other personal assets, including motor vehicles, furniture, tools used in business, and even cash (in some cases) are exempt. However, some assets are often clearly non-exempt, such as boats, weekend vacation cabins, and debtor-owned rental property. Many times, these assets are at least partially exempt, and even if they are not, the "garage sale" value principle discussed above once again comes into play.

Assume David Debtor has a non-running project car in his garage. Once the car is finished, it will probably have a substantial dollar value. But for now, it is only worth about $1,000. Moreover, the car is clearly non-exempt under both the federal and applicable state bankruptcy exceptions.

David is afraid that the bankruptcy trustee (person who oversees the case on behalf of the judge) will seize the car, sell it, and distribute the proceeds among the creditors, meaning that all the work and money David poured into the car would be gone. But not so fast. If the trustee did take David's car, the bankruptcy estate would incur significant expenses. After the car is seized, stored, cleaned up, and a sale price is negotiated (because almost no one pays the asking price), there may be few or no proceeds to distribute.

As a result, in situations like the project car, bankruptcy trustees often elect to let debtors hang onto non-exempt property. The same logic applies to fishing boats that need some work, rental properties that prior tenants trashed, and so on.

DEBTS

Most middle-class families fall into one of two categories: households that confront their debt problems and households that hide their debt problems. That's because most families have essentially no savings and over $130,000 in secured and unsecured debt. So, when life's financial storms hit, families must juggle payments instead of drawing on savings. This approach is often effective for a month or two, but putting off bills has a snowball effect. Three or four months down the road, a budget that was once barely feasible will essentially fall apart, and the financial news will more than likely only get worse. At that point, an old proverb rings true: "desperate times call for desperate measures."

UNSECURED DEBTS

Credit cards and medical bills are the two biggest unsecured debt categories, because the money-lender extends credit or provides services based solely on a written or oral promise to pay. Payday loans are also unsecured in most cases, although the moneylender would like for you to believe otherwise. Some furniture companies issue revolving-debt cards, like MasterCard and Visa, to allow customers to buy furniture on credit; these debts are also typically unsecured.

The procedural differences between a Chapter 7 and Chapter 13 are discussed below, but for now, suffice it to say that both these chapters eliminate these unsecured debts.

SECURED DEBTS

Home mortgages and vehicle loans are secured debts, because a third-party lender agreed to advance the purchase money for the property in exchange for a security interest in the collateral. In addition to monthly or periodic payments, security agreements often have other provisions as well, such as maintaining property insurance.

From a bankruptcy perspective, most secured debts are dischargeable. However, although a bankruptcy judge has the power to discharge the debt, the judge does not have the power to discharge the borrower's obligations under the security agreement. So, if the borrower defaults on payments or otherwise breaches the agreement, the moneylender can seize the collateral. The automatic stay, which is discussed below, often come into play regarding secured debts.

SPECIAL CATEGORY DEBTS

Not all debts are dischargeable with no strings attached, and most of the special category debts are somehow tied to state or federal governments.

DSOS AND TAXES

Domestic Service Obligations, including child support and spousal support, are almost never dischargeable in bankruptcy, regardless of the debtor's circumstances. Income tax debt is dischargeable only if it adheres to the 3/2/9 rule. First, the taxes must be at least three years past due. The due date is normally April 15, unless that date falls on a Sunday or holiday; if the taxpayer obtained any payment extensions, the due date is the first day after the last extension expires. Second, the returns must have been on file for at least two years. The IRS or state taxing authority sometimes files substitute returns on behalf of the taxpayer, and these substitute returns do not count. Third,

the debt must not have been assessed in the last 240 days. In most cases, that means the taxpayer has not received a collections letter in the past nine months.

These rules are very strict, and the IRS has been known to successfully object to discharge because the taxpayer's bankruptcy petition was filed just a few days too early. Moreover, as the Bankruptcy Code does not define "income tax," exactly what tax debts are dischargeable is largely at the taxing authorities' discretion. Finally, if the taxing authority filed a lien, that lien remains in force, because although the judge has the power to discharge the debt, the judge lacks the authority to discharge a lien.

STUDENT LOANS

Student loans, whether or not they were government-guaranteed, are likewise only dischargeable in some cases. When Congress amended the Bankruptcy Code in 1978, it did away with the unlimited-discharge rule in this area and limited discharge to cases that involve a "hardship." Probably because the provision was so controversial, lawmakers did not define this term and instead left it up to the courts.

A few years later, the Second Circuit Court of Appeals in New York decided Brunner v. New York State Higher Education Services Corporation (1982). Marie Brunner petitioned for discharge of her $9,000 student loan; even in 1982, that was not an extraordinary amount of money. Furthermore, the facts of the case indicated that rather than facing a hardship, Ms. Brunner simply did not want to repay her loan; viz, she was working at the time and filed her bankruptcy petition only a few days after the loan payments began.

Based on those facts, the court articulated a very harsh definition of "hardship," virtually ensuring that student loans could not be discharged unless the borrower became disabled or similarly unable to pay. Other courts quickly adopted the so-called Brunner Rule, and it effectively became the law of the land.

As the years passed and college tuition spiraled upward, student loan balances spiraled upward as well. In recent years, most courts have either questioned the Brunner Rule or overturned it altogether. One notable example is the Eighth Circuit's decision in Walker v. Sallie Mae (2011). Michelle Walker was unable to finish medical school and left with a staggering $300,000 student loan. She worked as a psychologist for a while and later became a stay-at-home mom to disabled twins. The court refused to consider the Brunner Rule and instead used a totality of the circumstances analysis that essentially examined the family's finances to determine if they could afford to repay the loans. In this case, although the $900 monthly loan payment would not have impoverished

the family, it would have been a significant burden, and the court deemed such burden sufficient to discharge the loan.

RENT

Evictions played a significant role in the 2005 bankruptcy reforms, as there was some concern (mostly from landlords) that tenants used bankruptcy to unduly delay the legal process. So, Congress carved out some exceptions to the automatic stay. If a judge has not signed a writ of possession (which is not the same thing as a finding that the tenant owes back rent), the automatic stay applies. If the judge has signed a writ, the automatic stay only applies if the tenants deposit one months' rent with the bankruptcy court and confess that they owe the amount of delinquent rent stated in the writ or judgment. Furthermore, the tenants must pay the entire delinquent amount within thirty days, or the landlords can enforce their writs.

WHAT IS THE PROCEDURE IN BANKRUPTCY?

Most consumer and small-business bankruptcies are filed under Chapter 7 or Chapter 13 of the Bankruptcy Code. There are some significant differences in terms of the types of debt each chapter addresses, the qualifications (or lack thereof), and a few other items. Procedurally, however, they have much in common.

AUTOMATIC STAY

Section 362 of the Bankruptcy Code is essentially a giant "stop" sign that moneylenders must obey. Just like there are some technical aspects to stopping at a stop sign, there are also some technical aspects to the automatic stay. If motorists proceed all the way to the curb before they stop, they are technically violating the stop-sign law in most states, because most vehicle codes require drivers to stop behind the stop line or behind the sign itself.

The automatic stay prohibits moneylenders from communicating with bankruptcy debtors for the purpose of collecting a past-due debt. In an abundance of caution, some moneylenders stop sending monthly statements, because these statements nearly always contain language like "please pay the past due balance of $100 immediately," and such statements could be construed as attempts to collect debts. Similarly, many moneylenders suspend automatic ACH withdrawals or other automatic payments once debtors file bankruptcy, because dipping into a checking account or charging

a credit card can be construed as a communication. If these debts are secured and the debtors wish to retain the property, these payments must still be made according to the security agreement.

More to the point, the automatic stay halts repossessions, foreclosures, and most lawsuits (the only prominent exception being eviction actions, as discussed above). Collections letters and phone calls are also clear violations of the automatic stay, and there are stiff penalties for violating Section 362. Although the stay technically takes effect when the voluntary petition is filed, the moneylender must also receive actual notice. Debtors must be sure they give their attorneys all relevant contact information, especially if there is an independent law firm handling the adverse action. If the debtor has never filed bankruptcy before, the automatic stay instantly goes into full effect; if the debtor has filed before in the last few years, the stay may have limited applications.

WHAT TO DO WITH PROPERTY

Debtors can either reaffirm secured debts, surrender the collateral, or redeem the collateral. A reaffirmation is basically an agreed extension of the existing repayment terms. Reaffirmation agreements can be red flags, as some trustees may ask fraud-related questions if the debtors reaffirm most or all of their original debts. Debtors who agree to surrender the collateral are normally not responsible for the difference in the fair market value of the property and the loan balance, and in many cases, especially with regard to vehicles, this difference can be significant. Most debtors either reaffirm the debt or surrender the collateral.

Redemption is normally limited to Chapter 13 repayment bankruptcies. Assume Denise Debtor has a used SUV with a $15,000 loan balance and a $7,500 fair market value. Some jurisdictions may allow Denise to redeem the SUV by paying the moneylender the fair market value, and if that happens, the loan is extinguished and Denise owns the SUV outright. The obvious catch is that Denise must pay $7,500 before the judge closes the bankruptcy.

Knowing what to expect in a bankruptcy makes the process less stressful. To take the first step towards the financial fresh start that you and your family deserve, contact us for a candid and confidential discussion of your situation.