

How Bankruptcy Changes the Landscape
(In the Foreclosure Context)

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I. The Automatic Stay

A. The Automatic Stay in General

The Bankruptcy Code protects debtors from actions by their creditors by imposing an “automatic stay” against actions to collect their debts. This automatic stay is set forth in 11 U.S.C. § 362. The purpose is "to facilitate the orderly administration of the debtor's estate." Brock v. Rusco Industries, Inc., 842 F. 2d 270, 273 (11th Cir. 1988).

Specifically, the automatic “operates as a stay, applicable to all entities, of”:

- (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title; *such as the filing of or proceeding in a lawsuit against the debtor*
- (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title; *i.e., the execution of a judgment against a debtor through garnishment, levy, or post-judgment discovery*
- (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate; *i.e., foreclosure, repossession, eviction, or unlawful detainer actions*
- (4) any act to create, perfect, or enforce any lien against property of the estate; *i.e., the filing of a judgment or materialman’s lien or an attempt to execute on the same*

- (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
- (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title; *i.e., all of the above, plus written demands, phone calls, etc...*
- (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
- (8) The commencement or continuation of a proceeding before the United States Tax Court concerning a corporate debtor's tax liability for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the date of the order for relief under this title. 11 U.S.C. § 362. *(comments added by author.)*

What is the "estate" that is created at the commencement of a bankruptcy case? It includes: "all legal or equitable interests of the debtor in property as of the commencement of the case, ... wherever located and by whomever held." 11 U.S.C. § 541. Thus, when a debtor files a bankruptcy petition a creditor is barred, without leave of court, from pursuing collection of its debt or pursuing wrongs that arose prior to the filing of the bankruptcy petition against a debtor or any property of the debtor.

B. Co-Debtor filings.

Except for one significant exception, the automatic stay applies only to the filing debtor and its estate. The automatic stay does not protect that debtor's family or their individual property

(as opposed to jointly-owned property.) Even though a debtor and their spouse are allowed to file a joint petition under § 302(a), the filing by one spouse independently does not stay action against the other spouse.

An individual debtor sometimes files a petition for itself and a closely held business as a joint case or lists the business entity as a d/b/a of the debtor. If the business listed is a separate legal entity, this is an invalid filing for the company. A separate case will technically be required in order to protect the assets of the entity. However, a cautious approach is to confirm the status of the entity and ownership of the assets, and potentially proceed after seeking authorization from the court through a stay relief or related motion.

The exception to this principal is provided by 11 U.S.C. §1301. That section creates a “co-debtor stay” that bars actions to collect **consumer** debts from non-debtor co-debtors in Chapter 13 cases. This provision provides in section (a) that:

Except as provided in subsections (b) and (c) of this section, after the order for relief under this chapter, a creditor may not act, or commence or continue any civil action, to collect all or any part of a *consumer* debt of the debtor from any *individual* that is liable on such debt with the debtor, or that secured such debt, unless--

(1) such *individual* became liable on or secured such debt in the ordinary course of such individual's business; or

(2) the case is closed, dismissed, or converted to a case under chapter 7 or 11 of this title.

Some relief is provided in certain situations, however, by paragraph (c):

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided by subsection (a) of this section with respect to a creditor, to the extent that--

- (1) as between the debtor and the individual protected under subsection (a) of this section, such individual received the consideration for the claim held by such creditor;
- (2) the plan filed by the debtor proposes not to pay such claim; or
- (3) such creditor's interest would be irreparably harmed by continuation of such stay.

11 U.S.C.A. § 1301

Keep in mind that this provision applies only to consumer debts, and protects only individual co-debtors rather than related entities. The stay applies only while the case remains open, and does not bar pursuit of co-debtors upon dismissal or discharge of the primary debtor. If one of the provisions of paragraph (c) applies, keep in mind that you must file a motion and obtain an order granting relief before you may proceed against the co-debtor.

C. Violation of the Automatic Stay

If the automatic stay provisions are violated, substantial penalties may be assessed against the offending creditor and possibly their attorney. A creditor must be aware of the concept of the automatic stay and immediately stop any and all foreclosure, repossession, or collection actions when it learns of the filing of a bankruptcy petition. Section 362(k) provides the following regarding violations of the stay:

- (1) Except as provided in paragraph (2), an individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.
- (2) If such violation is based on an action taken by an entity in the good faith belief that subsection (h) applies to the debtor, the recovery under paragraph (1) of this subsection

against such entity shall be limited to actual damages. (*Paragraph (h) requires a debtor within as set period of time to file a statement of its intention to either retain or surrender all personal property collateral.*)

II. Chapter 7, 13, and 11 Basics

A. Chapter 7

Chapter 7 is the most common type of bankruptcy filing in the U.S. It provides for the liquidation of the debtor's assets to be applied to its debts. A trustee is appointed to take control of the property of the estate, liquidate the estate, and distribute the proceeds pro-rata to the creditors. Additional powers and duties of the trustee include the right to object to claims, investigate the affairs of the debtor, file lawsuits on behalf of the estate, and oppose the debtor's discharge. 11 USC § 704. A bankruptcy court may authorize a Chapter 7 trustee to continue the debtor's business to increase the return to creditors but this is not common. 11 USC § 721.

The debtor's typical motivations for filing a Chapter 7 case are to stop collection efforts, retain exempt property, and receive a discharge of its debts. The Chapter 7 discharge releases individual debtors from personal liability for most debts and prevents creditors from taking any collection actions against the debtor. As discussed in more detail later in these materials, some debts are excepted from Chapter 7 discharge. An individual debtor will receive a discharge within 60 to 90 days from the date first set for the meeting of creditors. Non-individual debtors do not receive a discharge and are simply dissolved.

Asset v. No Asset Cases. The trustee's role in a Chapter 7 case is to administer the case, take control of the assets and liquidate the debtor's non-exempt assets. 11 USC § 701, 704. In a case where non-exempt assets exist, it is the trustee's duty to liquidate the assets in a manner that

maximizes the return to the unsecured creditors and sell any non-exempt property if it is free and clear of liens (or if sufficient equity exists.) The trustee may attempt to recover money or assets under the trustee's avoiding powers. The trustee is granted the power to set aside preferential transfers made to creditors within 90 days before the petition and undo security interests and other pre-petition transfers of property not properly perfected at the time of the petition. They may also pursue claims such as fraudulent conveyances available under state law and may pursue any lawsuits or causes of action the debtor possesses at the time the case is filed.

In order to participate in any distribution by the trustee, the creditor will need to file a proof of claim in the case. If the case was filed as an asset case, a notice will typically go out to creditors advising of a date 90 days from the creditors meeting by which a creditor must file a claim. If a case is filed as a no asset case, but assets are later discovered, a notice will be entered setting a deadline by which claims must be filed. A creditor must file its claim by this deadline in order to participate in any distribution. A secured creditor, however, does not forfeit its security interest or lien by failing to file a claim.

Most Chapter 7 cases filed on behalf of individuals, however, are no asset cases. If the debtor lists no non-exempt assets in its schedules, and it appears that there are no additional assets at the conclusion of the meeting of creditors, the trustee will file a "no asset" report with the court. In these cases, there will be no distribution to the creditors and the debtor is typically awarded a discharge shortly after the report is filed.

Reaffirmation Agreements. Secured creditors retain their right to foreclose and take possession of property securing an underlying debt even after discharge is granted. A debtor seeking to retain the secured property may decide to reaffirm the debt. A reaffirmation agreement

is negotiated between the debtor and creditor and provides that the debtor will remain liable on the debt and will pay all or a portion of the balance owed (typically by resuming monthly payments) even though the debt would otherwise be discharged in bankruptcy. The creditor typically agrees that it will not repossess the property as long as the debtor continues to pay under the terms of the agreement.

A reaffirmation agreement must be filed before the discharge is granted. Reaffirmation agreements are required to contain an extensive set of disclosures found in 11 USC § 524(k). These include the amount of the debt, how the debt was calculated, and that the debt will not be discharged in bankruptcy. The debtor must sign the agreement and a disclosure as to his or her current income and expenses and provide to the court a showing that debtor can afford to make the payments on the debt reaffirmed. If the debtor cannot meet this requirement, there is a presumption that the agreement would create an undue hardship, and the court may not approve the reaffirmation agreement.

Debtor's counsel must also sign the reaffirmation agreement certifying that they have advised debtor of the legal effect of the agreement, that the debtor is fully informed, that the debtor voluntarily made the agreement, and that reaffirmation of the debt will not create an undue hardship. The debtor retains the right to rescind the agreement upon notice to the creditor at any time before a discharge or is granted or within sixty days of the filing of the agreement with the court.

Non-dischargeability and Objection to Discharge. Discharge is the Chapter 7 debtor's goal. Discharge absolves the debtor from personal liability for discharged debts and stops creditors from taking action against the debtor or his property to collect the debts. A discharge of all pre-

petition debt will be granted unless a debtor fails to meet the basic requirement set out in the bankruptcy code, an adversary proceeding (basically, a lawsuit within a bankruptcy case) is filed objecting to the discharge or the dischargeability of a particular debt, or the debtor has debts falling into a category of debts that have been determined to be nondischargeable.

The grounds for denying an individual debtor a discharge in a Chapter 7 case are fairly narrow and are typically construed in favor of the debtor. They fall into two basic categories: exceptions to discharge of specific debts under §523 and objections to discharge in general under §727.

Grounds for denying a discharge under §727 include transfer or removal of property of the estate, failure to produce adequate financial records; the making of false statements in connection with the bankruptcy filing; failure to adequately explain loss of assets; commission of a bankruptcy crime such as perjury; failure to obey a lawful order of the bankruptcy court; fraudulently transferring, concealing or destroying property that would be property of the estate; and that the recent grant of a discharge to the debtor in another case where the majority of creditors were not paid.

Specific debts that may be excepted from discharge under §523 include debts: for certain taxes; for money obtained through fraud or the use of false statements (such as a fraudulent credit application); not disclosed at the time of filing; for fraud while the debtor was acting in a fiduciary capacity; for child or domestic support; for certain willful injuries; for certain governmental fines and penalties; student loans; for deaths caused by debtor's operation of a motor vehicle while intoxicated; for alimony; or for criminal restitution and certain other governmental obligations.

Three of the types of debts set out in §523 as exceptions to discharge can still be discharged unless the creditor files an adversary proceeding in bankruptcy and requests a determination by

the court that the debts should not be discharged. Those exceptions are: (a)(2) – for money obtained through fraud or use of false statements regarding the debtor’s financial condition; (a)(4) – for fraud or defalcation while the debtor was acting in a fiduciary capacity; and (a)(6) for willful and malicious injury.

B. Chapter 13

Chapter 13 provides for the readjustment of the debts of individuals with regular income. The purpose of Chapter 13 is for the debtor to be able to submit a plan and have it confirmed by the court that commits some portion of the debtor's future income to pay creditors for either three or five years. The Chapter 13 trustee oversees the administration of the bankruptcy case, confirmation, and execution of the Chapter 13 plan through receiving and disbursing the debtor’s monthly payments, but does not have the same responsibilities as a Chapter 7 trustee. The debtor remains in possession and control of the bankruptcy estate and can exercise some, but not all, of the powers of a Chapter 7 trustee. To be eligible for Chapter 13, an individual must have less than \$336,900.00 of unsecured debt and less than \$1,010,650.00 in secured debt. 11 USC § 109(e).

Chapter 13 offers individuals with substantial assets an advantage over liquidation under Chapter 7. The debtor has the opportunity to save its home from foreclosures and vehicles from repossessions. The delinquencies on these loans can even be cured over time. A debtor can also reschedule secured debts (other than a mortgage on the debtor’s primary residence) and extend the payments over the life of the Chapter 13 plan. This allows the debtor to lower the payments. Also, debtor may alter the interest rate on debts other than mortgage debt.

An individual cannot file a Chapter 13 case if, during the preceding 180 days, a prior bankruptcy was dismissed due to the debtor's willful failure to comply with orders of the court or

was voluntarily dismissed after a creditor sought relief to recover its collateral. A Chapter 13 debtor must also receive credit counseling within 180 days prior to filing.

Means Test: Certain individuals may not qualify to file a petition under Chapter 7, and will be forced to have their case converted to a Chapter 13 case or dismissed under §707. These are generally individuals with the majority of their debt being consumer debt and that have incomes exceeding the applicable median income of a family of their size in their geographic area. This test is generally referred to as the bankruptcy “means test.” Under §704(b) and (c), a debtor is required to provide certain financial information to the trustee and a determination will be made and provided to the court as to whether the debtor qualifies to proceed with a Chapter 7 case under the means test. The means test is also used to determine whether the length of the debtor’s Chapter 13 plan will be limited to three years (for debtors with less than the median income) or five years (for debtors exceeding the median income.)

C. Chapter 11

Chapter 11 governs business reorganizations and liquidations. Both individuals and entities may be debtors under Chapter 11. Generally, the debtor remains in control of its assets and manages its affairs, subject to court oversight, as a debtor-in-possession under sections 1107 and 1108. The DIP owes a fiduciary duty to creditors and the bankruptcy estate and exercises most powers of a Chapter 7 trustee. In situations involving fraud, dishonesty, or incompetence of the DIP, or when in the best interest of creditors, the bankruptcy court may appoint a trustee to take control of a Chapter 11 case under §1104.

The purpose of Chapter 11 is to allow the filing and confirmation of a plan of reorganization allowing the debtor to emerge from bankruptcy with restructured debt. This confirmed plan of

reorganization operates as a contract between the debtor and all creditors and supersedes any prior agreements between the debtor and creditor. A plan often alters the debtor's repayment terms. In some cases, a Chapter 11 plan provides for the orderly liquidation of the DIP and its assets. In this situation, the DIP will remain in control of its assets and liquidate the estate for the benefit of creditors.

D. Chapters 9 and 12

Other Chapters include Chapter 9 (municipal bankruptcies), and Chapter 12 (bankruptcy for family farmers). You should basically be aware that these exist. You may be aware of Chapter 9 filings due to the Jefferson County filing. Although these filings are becoming more common, they are still extremely rare. Chapter 12 filings are unusual outside a few heavily agricultural states. States where these filing have been most common recently are California, Wisconsin, Minnesota, Oklahoma, Pennsylvania, Kansas, and Georgia. (Interestingly, there were ten such cases filed in Georgia during the first quarter of 2013, and only one filed in Alabama according the U.S. Bankruptcy Courts quarterly reports.)

III. Post-Foreclosure Sale Bankruptcy Filing

In Alabama, a bankruptcy filed after the foreclosure sale is conducted does not impact the foreclosure. In re Cottrell, Bkrtcy.M.D.Ala.1996, 213 B.R. 378. This is because the foreclosed property is no longer property of the estate after the sale is completed, and is true even if the foreclosure deed has not been recorded at the time of filing. In re Morgan, 06-30531 DHW, 2006 WL 2338147 (Bankr. M.D. Ala. Aug. 9, 2006). The one-year statutory right of redemption

belonging to the debtor, however, would become property of the estate and could be exercised by the trustee or DIP.

IV. Protecting the Creditor's Position

Relief from the Automatic Stay

Upon receipt of notice of a bankruptcy filing and confirming that the filing stays your pending foreclosure, your next step is often to assess whether there is a possibility that you can obtain relief from the bankruptcy court to allow you to proceed with foreclosure. The bankruptcy code does allow creditors, in certain circumstances, to obtain relief from the automatic stay and proceed with foreclosure or repossession after a bankruptcy filing. As set forth in 11 USC §362(d):

On request of a party in interest and after notice and a hearing, the court **shall** grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay--

(1) for **cause**, including *(but not limited to)* the lack of adequate protection of an interest in property of such party in interest;

(2) with respect to a stay of an act against property under subsection (a) of this section, if--

(A) the debtor **does not have an equity** in such property; **and**

(B) such property **is not necessary to an effective reorganization;**

(comment added by author)

(3) with respect to a stay of an act against **single asset real estate** under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for

relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later--

(A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

(B) the debtor has commenced monthly payments that--

(i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and

(ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate; or

(4) with respect to a stay of an act against real property under subsection (a), by a creditor whose claim is secured by an interest in such real property, if the court finds that the filing of the petition was part of a **scheme to delay, hinder, or defraud creditors** that involved either--

(A) transfer of all or part ownership of, or other interest in, such real property without the consent of the secured creditor or court approval; or

(B) multiple bankruptcy filings affecting such real property.

If recorded in compliance with applicable State laws governing notices of interests or liens in real property, an order entered under paragraph (4) **shall** be binding in any other case under this title purporting to affect such real property filed not later than 2 years after the date of the entry of such order by the court, except that a debtor in a subsequent case under this title may move for relief from such order based upon changed circumstances or for good cause shown, after notice and a hearing. Any Federal, State, or local governmental unit that accepts notices of interests or liens in real property shall accept any certified copy of an order described in this subsection for indexing and recording.

"Cause" sufficient to modify the automatic stay is not defined in the Bankruptcy Code or detailed in applicable legislative history, but is not limited to lack of adequate protection as set out in (d)(1). In re M.J. & K. Co., Inc., 161 B.R. 586, 590 (Bankr. S.D.N.Y. 1993). What constitutes "cause" for stay relief purposes "... is an intentionally broad and flexible concept which must, of necessity, be determined on a case by case analysis." Matter of Holly's Inc., 140 B.R. 643, 687 (Bankr. W.D. Mich. 1992). The moving party has the burden to make an initial showing of "cause" for relief from the stay. *See*, In re Sonnax Industries, Inc., 907 F.2d 1280, 1285 (2nd Cir. 1990). "Once cause is shown to exist, the debtor must prove that it is entitled to the protections afforded by the stay." In re M.J. & K. Co., Inc., 161 B.R. at 590. Further, pursuant to §362(g), the moving party bears the burden of proof on the debtor's equity in the property but the debtor bears the burden of proof on all other issues.

II. Noteworthy Decisions