

Rees Broome, PC

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Bankruptcy: An Overview

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Many of our clients begin the assessment collection process against a delinquent owner only to learn that the owner has filed for bankruptcy protection. We understand that bankruptcy filings are a source of frustration for many of our clients, and have therefore prepared a summary of how the current U.S. bankruptcy laws affect our community association clients.

An individual may file for either Chapter 7 or Chapter 13 bankruptcy protection under the U.S. Bankruptcy Code. While the filings and outcomes are similar in some aspects, they are very different in others.

In the context of community associations, once a debtor files for either type of bankruptcy protection, the date on which he filed becomes known as the “petition date”, and the account balance as of this date is now known as the “pre-petition balance”, while all amounts that come due after the petition date are known as the “post-petition balance.”

When a debtor files for bankruptcy under either Chapter 13 or Chapter 7, the debtor’s ultimate objective is to receive a discharge of his or her debts. In other words, the debtor is seeking to be relieved of his or her personal responsibility to repay those debts. It is important to emphasize that the debtor is relieved only of his or her personal liability – any claims against the property might survive. For example, liens recorded before the debtor files for bankruptcy

will survive, and while the debtor cannot be sued for the pre-petition debt, the creditor could foreclose its lien.

An automatic bankruptcy stay also becomes effective on the petition date that remains in effect until the bankruptcy is dismissed or the owner is discharged by the bankruptcy court. This means that community associations and all other creditors are prohibited from taking action against the debtor to collect a debt owed by the debtor unless the creditor first receives permission from the bankruptcy court. The bankruptcy protection also applies to property owned by the debtor, such as the debtor’s home and vehicles, which then becomes known as the bankruptcy estate. For our purposes, once the debtor has filed for bankruptcy protection, the association cannot not take any action that affects the bankruptcy estate, including recording a lien against title to the property, foreclosing on the property or levying on a vehicle in order to enforce a judgment.

Chapter 13 Bankruptcy

In short, a Chapter 13 bankruptcy is one in which a debtor enters into a court-approved payment plan in order to repay all his or her debts. Generally, a debtor who files for Chapter 13 protection is an individual who is employed and is seeking to retain his assets. In these cases, the individual will create a Chapter 13 Plan, where he agrees to make monthly payments into the Court for a period of up to 60

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months, which should provide the debtor with sufficient time to pay back all of the secured pre-petition debt and most, if not all, of the unsecured pre-petition debt. In addition, debtors are required to continue making their regular post-petition payments directly to their creditors. However, before a creditor can receive payments for any pre-petition debt under the Plan, the creditor must submit a Proof of Claim, indicating the amount of money the debtor owes to the creditor as of the petition date. The creditor will then receive monthly trustee payments over the next several years until the pre-petition debt, as stated in the Proof of Claim, is paid in full.

Often, a debtor will fail to include the correct amount due to a creditor in their Chapter 13 Plan. Under these circumstances, the creditor will have to file an Objection to Confirmation of the Plan to ensure that the correct pre-petition debt is reflected in the Chapter 13 Plan. Once the Objection has been filed, the Bankruptcy Court will hold a Confirmation Hearing and will not allow the debtor to enter into the payment agreement until the amount of the claim is resolved. After the Court approves the Plan, the Plan is deemed confirmed. Once the debtor has completed his or her Plan, the debtor is discharged and the bankruptcy case is closed.

Chapter 7 Bankruptcy

Unlike a Chapter 13 case, a debtor who files for Chapter 7 is usually unable to repay his or her creditors. Because the debtor is completely released from his or her responsibility for his or her debts, recent changes to the bankruptcy laws were made to curtail abuse of this section of the Bankruptcy Code. In light of the current downward trend in the real estate market, however, debtors are obviously still filing under Chapter 7. Unfortunately, these cases also signal that any mortgage holders will soon be foreclosing on the debtor's property.

There are two types of Chapter 7 bankruptcy cases: an "asset" case and a "no asset" case. What separates the two cases is whether the debtor has assets valuable enough to sell in order to pay the debtor's creditors. In an "asset" case, a debtor's property will be sold and liquidated by the bankruptcy trustee in order to pay as many creditors as possible, with the remaining debts being discharged. In a "no asset" case, on the other hand, a debtor's assets will be foreclosed or repossessed by the debtor's creditors and all remaining debts will be discharged by the court. In "no asset" cases, creditors should not expect repayment of the debt.

From the petition date to the discharge date, a typical Chapter 7 case lasts approximately four to six months. Typically, we simply monitor the bankruptcy on behalf of our clients and take action, if appropriate, once the bankruptcy case is closed.

Collection of Post-Petition Assessments

Again, in either type of bankruptcy filing, associations are prohibited from taking collection action to collect the pre- or post-petition debt while the bankruptcy is pending. However, an association is permitted to send letters requesting payment of delinquent post-petition assessments, as well as file suit and obtain a judgment for the post-petition delinquency. The association may also be able to record a lien against the title to the property. However, the association cannot take action to collect the judgment (such as file a garnishment) or enforce its liens (i.e., foreclosure).

In some cases, we may recommend that the Association request relief from the automatic bankruptcy stay in order to pursue aggressive post-petition action against a debtor. We may make this recommendation in situations where the post-petition debt is significant and

foreclosure becomes appropriate or when extreme covenant violations exist at the property that must be corrected by either the debtor or the Association. Unfortunately, the Bankruptcy Court is often reluctant to grant such relief to a community association. While it is unlikely that the association will be given leave to foreclose, the Court may authorize other action and it may prompt the debtor to bring his or her post-petition account current.

Although Boards may find a debtor's bankruptcy filing to be frustrating, all is not usually lost. In many ways, bankruptcy is simply a delay of the inevitable. The debtor must either repay the debt, or lose title to the property. In addition, the recent bankruptcy reform has greatly curtailed the serial filings that so many associations found particularly frustrating. One way or another, bankruptcy usually forces a resolution of an otherwise difficult case.

As always, please contact any one of our community association attorneys if you have further questions about the bankruptcy process.