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BANKRUPTCY: ONE WAY TO AVOID FORECLOSURE

By David A. Blansky

Introduction

Mortgage delinquencies and foreclosures surpassed record levels in the first quarter.¹ According to a recent report from the Administrative Office of the U.S. Courts “[t]here were 901,927 bankruptcy cases filed in the 12-month period ending March 31, 2008, a total that is 30 percent higher than the 695,575 filings for the same period ending March 31, 2007. The 245,695 cases filed in the first quarter of 2008 is the highest quarterly total since 2005.”² More than 4,000 were filed per day in March and April of this year.³

Approximately four of ten bankruptcy filings today are made under Chapter 13. This is an increase from three of ten filings from two years ago. This is partially attributable to the 2005 changes in the bankruptcy law. The new law was designed, in part, to shift more filing to Chapter 13 from Chapter 7 as the former results in the forgiveness of less debt than the latter.⁴

The use of bankruptcy to halt foreclosure is greatly responsible for the growth in consumer bankruptcy filings as debtors recognize that bankruptcy is one means of avoiding foreclosure.⁵

Bankruptcy

The commencement of a bankruptcy case results in two important initial events. First, a bankruptcy estate is created. Second, a stay is automatically imposed enjoining any action to collect a debt against a debtor or enforcing such debt against property of his bankruptcy estate. Each of these events has significant implications in the foreclosure context.

¹ Ruth Simon, “Housing Pain Hits Prime Borrowers”, Wall St. J., June 6, 2008 at A5.

² News Release, Administrative Office of the U.S. Courts, Bankruptcy Filings Up in March, June 3, 2008 at http://www.uscourts.gov/Press_Releases/2008/BankruptcyFilingsMar2008.cfm.

³ Jennifer Barrett, “The Bankruptcy Boom”, Newsweek Online, May 21, 2008 at <http://www.newsweek.com/id/138151/output/print>.

⁴ Amy Merrick, “More Debtors Use Bankruptcy To Keep Homes” Wall St. J. Online, October 23, 2007 at http://online.wsj.com/article/SB119309633953367729.html?mod=hps_us_whats_news.

⁵ The increase in filing may also attributable to the fact that there now exists legal precedent with respect to numerous provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Pub.L. 109-8, 119 Stat. 23), which was enacted on April 20, 2005.

Property of the Estate

Upon the filing of a bankruptcy petition, an estate is created comprised of all of a debtor's legal and equitable interests in property under 11 U.S.C. § 541. The bankruptcy estate is subject to exemptions available under applicable law and declared by the debtor in his petition.⁶

Title 11 of the United States Code (the "Bankruptcy Code") recognizes that property interests are created under and defined by state law. Once a property is sold at a foreclosure sale in New York, the property owner's interest in the property is extinguished regardless of when the referee's deed is delivered to the prevailing bidder. There is no right of redemption once the foreclosure sale has concluded.

Thus, filing for bankruptcy protection following a foreclosure sale will not allow a debtor to redeem his property. In those instances where the gavel has already fallen, bankruptcy is no longer a means of avoiding foreclosure.

The Automatic Stay

Regardless of the section under which a debtor files for bankruptcy, the automatic stay imposed by 11 U.S.C. § 362(a) is equivalent to a temporary injunction against virtually all creditor activity that might have the effect of advancing the creditor's interest at the expense of the debtor or property of the debtor's estate. The automatic stay provides the debtor immediate calm amidst the storm of his financial difficulties. Creditors are bound by the stay as of the moment of commencement even before receiving notice of the bankruptcy filing. However, the stay does not prevent action by a creditor against a party other than the debtor (e.g., a co-debtor, guarantor, insurer or surety).

Where filed on the eve of a foreclosure sale, the prudent debtor should notify the foreclosing party and/or the referee conducting the sale so that the sale will be averted. A "Notice of Bankruptcy Case Filing", evidencing the filing, can be obtained from the Clerk.

The stay is automatically imposed in first time filings but may not be available in subsequent filings depending on the timing of the subsequent filings and the outcome of the earlier case(s).⁷ In instances of repeat filings, out of an abundance of caution, some creditors will seek "comfort" orders vacating stay in to confirm that the stay is no longer in effect so that they do not violate the stay.

Chapter 7

A filing under Chapter 7 of Title 11 of the United States Code results in a liquidation proceeding. Subject to a debtor's statutory exemptions, his assets are liquidated to satisfy his debts. In exchange, he receives a discharge from his debts other than his secured debts, certain priority debts (e.g. child support, certain tax liabilities) and student loan debts.

⁶ As New York State has elected to opt-out of federal exemptions, the exemptions for New York State residents may be found in Debtor and Creditor Law Sections 282 through 284 and Civil Practice Law and Rules 5205 and 5206.

⁷ Where a debtor has been in one prior bankruptcy case which has been dismissed within the year prior to the current case, 11 U.S.C. § 362(c)(3) provides that certain protections of the automatic stay terminate on the 30th day unless a motion to extend the stay is filed and heard before the 30th day.

Until the 2005 changes in the bankruptcy law, there existed a presumption that bankruptcy filings were made in good faith unless a demonstration to the contrary was made in a case. The 2005 amendments resulted in an assumption that a filing was made in bad faith unless a debtor satisfied the “means test” and certain other criteria as a condition precedent to filing for bankruptcy and obtaining a discharge in his bankruptcy case. These changes have made it that much more difficult to file for bankruptcy.

While Chapter 7 debtors facing foreclosure will benefit from the automatic stay, that benefit may be temporary in many cases where there exists little, if any, equity in the debtor’s real property as of the filing date. The mortgage holder, being a secured party, will often move promptly to vacate the stay under 11 U.S.C. § 362(d) or (e). The burden of proof on the issue of the debtor’s equity in the real property is on the moving party. See 11 U.S.C. § 362(g). Where the secured party demonstrates that it is not adequately protected by the equity existing in the real property, it is likely to be granted relief from the automatic stay so that it may enforce its remedies as against the real property, including foreclosure.

In some instances, the breathing room provided by a Chapter 7 filing may be sufficient to allow a voluntary sale of the real property by the debtor. However, where there exists little or negative equity as of the filing date, a Chapter 7 filing is likely to only briefly delay the inevitable foreclosure proceeding.

Chapter 13

A Chapter 13 filing allows a debtor to reorganize her financial affairs and to pay a percentage of her debts under a confirmed plan extending from three to five years. The amount of a debtor’s monthly payment is determined by several factors such as the amount of her debt, her ability to repay and the extent that she has assets.

As a result, a filing under this Chapter can be an effective means of staving off foreclosure for those who qualify as Chapter 13 debtors. To qualify, a debtor must have regular income and must stay current on her new bills. In a Chapter 13 bankruptcy, a debtor will pay the arrears due on her mortgage over the course of her plan, rather than at one time to save her property from foreclosure.

However, a debtor who fails to make her payments under her plan may face a motion by her secured creditor to vacate the automatic stay and/or the conversion of her case to one under Chapter 7. An unforeseen event such as illness, job loss or emergency home repair can result in the failure of a debtor to meet her obligations under her plan.

To succeed, a Chapter 13 plan must be realistic. The use of a Chapter 13 filing may best benefit a debtor having a fixed-rate mortgage or those homeowners having an adjustable-rate mortgage that is not going to reset itself during the life of the Chapter 13 plan.

Where a debtor has negative equity in her home, a Chapter 13 proceeding may even provide a means of stripping a second mortgage or home equity line of credit (“HELOC”) where that second mortgage or HELOC is completely unsecured by the equity in the real property as a result of a decrease in the value of the debtor’s home. In that scenario, the holder of the second mortgage or HELOC is treated in the same manner as every other unsecured creditor. Should a debtor make all of the payments required under her plan, that second mortgage or HELOC may be discharged as a result of the bankruptcy case.

While a Chapter 13 plan may modify the rights of certain secured creditors, the present bankruptcy law does not permit the modification of a mortgage secured by a primary residence, but does allow modification to the rights of creditors secured against real property other than the debtor’s primary residence. See 11 U.S.C. 1322(b)(2). Those creditors who are not secured against the debtor’s primary residence face the prospect of a repayment plan forced upon them if the bankruptcy court confirms the debtor’s plan. Where the negative equity in a primary residence is such that the lender is no longer secured against the primary residence, a debtor may be able to modify or extinguish the loan.

Conclusion

A bankruptcy filing is an important tool in the arsenal of any attorney defending against a foreclosure and should be considered where work outs, consensual loan modifications or short sales are either unavailable or have failed.

As Federal Rule of Bankruptcy Procedure 9011 obligates any counsel filing a bankruptcy petition to engage in a certain level of diligence in connection with any filing as he or she may be subject to sanctions, any attorney utilizing bankruptcy to halt a foreclosure should take great pains to investigate his client’s financial affairs and to comply with the filing requirements and deadlines promulgated under the Bankruptcy Code.