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When an Owner is in Bankruptcy

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The occurrence of bankruptcy is becoming more frequent during the collection process. Owners who are over their heads in debt are seeking the protection of the bankruptcy courts to help eliminate or reduce their debts. Recovery aside, this trend is likely to continue as rates adjust for 5 year adjustable rate mortgages issued in 2006, the end of the housing boom, or as they require payoff in the coming year.

Unfortunately for associations, in many instances the bankruptcy of an owner will make past due sums unrecoverable. This results in the Association having to write off the assessments. The bankruptcy process begins when the debtor owner files a petition for bankruptcy protection. The date of the filing is the "Petition Date." On that date, the court creates the Bankruptcy Estate which consists of the debtor's assets and liabilities. These assets come under the control of the Bankruptcy Trustee, an individual appointed by the court to oversee the assets for the benefit of creditors.

On the Petition Date, a Stay is placed against the collection of all debt which accrued prior to the Petition Date ("Pre-Petition Debt") which prevents attempts to collect on Pre-Petition Debt. After successful completion of the bankruptcy process, the Stay is replaced with a

Discharge injunction to prevent collection of the Pre-Petition Debt.

The association, or its management agent, will be notified of the bankruptcy filing by receipt of a Notice of Chapter 7 Bankruptcy Case, Meeting of Creditors & Deadlines. This notice gives the Petition Date. Counsel should immediately be informed of such notice. Any attempts to collect on Pre-Petition Debt can be subject to sanctions by the bankruptcy court. Attempts to collect debt include suspension of pool or other privileges due to the prior non-payment of assessments. Assessments due after the petition date are not dischargeable in bankruptcy ("Post Petition Debt"), so privileges may again be suspended, after proper notice and hearing, for Post Petition Assessments.

The majority of debtors will file for protection under either Chapter 7 or 13 of the Bankruptcy Code. Under Chapter 7, the debtor is looking for forgiveness of their debts ("Discharge"). Assets are liquidated, and if there is any money, creditors may receive pennies on the dollar. Chapter 7 is individual to the debtor who files. If a co-debtor does not file for bankruptcy, the full amount of the assessments can be collected from the co-debtor.

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Typically, during the course of the Chapter 7, the lender on the property receives permission to foreclose on the property, and there are limited Post Petition assessments to collect. However, banks are not timely foreclosing on properties, and there may be significant Post Petition Assessments which can be collected from the Discharged owner.

Under Chapter 13, the debtor is looking to minimize debts and increase the time frame in which to pay debts. Chapter 13 extends the Stay to any co-debtors thus preventing action against a co-debtor unless the Association seeks leave of the court to pursue the debt against the non-bankruptcy owner.

Debts fall in to two classes secured and unsecured. Typically association assessments are secured by the property, by a lien and/or judgment lien if there is sufficient equity in the property.

The Chapter 13 debtor must file a plan of reorganization showing how secured creditors are to be paid off. Unsecured creditors will be paid a percentage of what they are owed. If there is not sufficient equity in the property to cover the association's liens, the association can be treated as an unsecured creditor.

Liens are tied to the property and not the owner and can survive the bankruptcy. Unfortunately, if the property is valued at less than what is owed on it (underwater), liens and judgment liens can be stripped from the property.

Lien stripping is becoming more prevalent. Lien stripping requires proof to the court that amounts owed on the property, mortgage and liens, exceeds the worth of the

property. Once this is proved, the liens will be subject to being voided and removed once the debtor completes the Chapter 13 payment plan and receives a discharge.

In both 13's and 7's, the objective of the debtor is to receive a discharge. If they fail to make necessary appearances, filings, or payments their bankruptcy can be dismissed and collections can begin again on the entire balance due to the association.

Bankruptcies will often result in a result which appears inequitable to associations which are required to provide certain benefits. It must be remembered that bankruptcy's intent is to give the debtor a fresh start. Careful monitoring of bankruptcy cases is required to ensure that association's interests are protected to the maximum extent possible.

Quick Reference Terminology

- Petition Date
 - The date on which the bankruptcy is filed
 - All Debtors assets and liabilities are put into the bankruptcy Estate
- Bankruptcy Estate
 - All the debtor's assets and liabilities which come under control of the Bankruptcy Trustee
- Bankruptcy Trustee
 - Individual appointed by the court to administer the assets and liabilities of the Bankruptcy Estate Stay
 - The Stay prevents actions to collect pre-petition debt
- Pre-Petition Debt
 - Those debts incurred prior to the Petition Date

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- Post Petition Debt
 - Debts incurred after the Petition Date
- Chapter 7 Bankruptcy (I Give Up)
 - Debtor is asking to be forgiven of all debts
- Chapter 13 Bankruptcy (Keep them off my back)
 - Debtor is seeking to reorganize debts
- Conversion
 - Debtor converts from one chapter to another
- Discharge
 - Forgives debts owed
- Dismissal
 - Case is closed without discharge – Debtor still owes
- Notice of Appearance
 - Filed to have court send updates on accounts
- Bifurcation Letter
 - Letter to management to let them know to split account into Pre-Petition and Post-Petition accounts
- Lift Stay
 - Asking the bankruptcy court to let you proceed against assets of the bankruptcy estate
- Proof of Claim
 - Shows how much is owed to a creditor and why
- Lien Stripping
 - Mechanism to strip liens off of the property when it is underwater
- Co-Debtor
 - Someone else who owes the same debt