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## *Community Associations Newsletter*

### Chapter 7 Bankruptcy Overview

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The primary purpose of the bankruptcy courts is to give debtors a fresh start free from their debts. Unfortunately for community associations, the fresh start often results in a loss of assessment income.

Debtors must meet threshold levels of income and debt in order to be eligible to apply for bankruptcy protections. When the thresholds are not met, the bankruptcy can be found to be an abuse. The bankruptcy trustee, who is appointed by the court to review and marshal the debtor's bankruptcy, makes this determination based upon the debtor's assets and liabilities. The trustee becomes a holder of the debtor's assets during the bankruptcy. The trustee will determine if there is a benefit to the creditors in selling the debtor's assets to satisfy the debtor's outstanding debts.

As part of the trustee's evaluation process, the trustee holds a hearing at which the debtor must appear and answer questions about his or her assets and liabilities, and any peculiarities the trustee has found in the debtor's petition. Creditors may be present at the hearing (known as a 341 hearing) and question the debtor regarding their assets and intent towards the property.

As this is the same information that the debtor must include in their bankruptcy petition, there is usually little benefit to the association in being represented by counsel at such hearings. The exception would be if the association knows of any unusual income streams or assets which the debtor did not declare in their bankruptcy petition.

When a debtor files for Chapter 7 bankruptcy, they are looking for forgiveness of all debts which came due prior to the date on which they filed for bankruptcy protection (their Petition Date). On the petition date, a "stay" goes into effect prohibiting the association and other creditors from seeking to recover debts which accrued prior to the Petition Date.

When a bankruptcy petition is filed, the debtor will send a notice to all creditors whom they list in their bankruptcy schedules. Depending on how the debtor lists the association in their petition, the notice may be sent to the association, management, or to the association's legal counsel. If the association or manager receives a notice of bankruptcy, the notice should immediately be forwarded to the attorney responsible for your collections so they can halt any pending collection actions. If collection actions are not halted, the debtor could seek to

recover damages from the association for violating the bankruptcy stay.

While it is straightforward that associations cannot attempt to collect assessments through judicial proceedings during the bankruptcy stay, it should also be noted that associations cannot withhold services or access to amenities based upon a pre-petition debt. If the association has revoked a debtor's parking or restricted the debtor's access to amenities based upon a pre-petition delinquency, those benefits need to be reinstated to the debtor in order to avoid a complaint that the association is violating the stay by using those amenities to leverage payment of the pre-petition debt.

It should be noted that the association may re-suspend such access to the amenities once the debtor becomes delinquent on assessments that come due after the petition date. So that it is clear that the suspension is purely related to post-petition delinquencies, the association should again give the required notice of hearing and follow its due process policies when re-suspending privileges based upon a post-petition delinquency.

Associations should also be aware that if they recently received a payment from the debtor via garnishment in the 90 days preceding the debtor's bankruptcy filing, the trustee or debtor may petition the court to have the payment returned to the debtor or court as a "preference payment." Any such petition will result in a court hearing to determine if return of the funds is appropriate.

It typically takes 120 days for a Chapter 7 bankruptcy to conclude. During the course of the bankruptcy, the trustee determines if there are sufficient assets that can be auctioned off to satisfy any substantial portion of the debts owed to the creditors.

If the trustee determines that assets can be sold for the benefit of creditors, the trustee will issue a call for claims. At this point, a Proof of Claim may be filed alerting the trustee of the association's claim. The trustee will then evaluate all of the claims filed and proceed with a sale of the debtor's assets and pay all creditors a proportional share of the funds recovered from the sale of the debtor's assets. It is not common to see a call for claims in a Chapter 7 bankruptcy.

During the course of the Chapter 7 bankruptcy it is more common to see the first trust mortgage holder file for relief from the bankruptcy stay so that it may proceed with foreclosing on the property. If the property's value exceeds the mortgage on the property the trustee will not object to the bank's request, as the property is without value to the trustee as an asset to sell for the other creditors (the trustee would first have to pay off the bank's lien) and the court will grant the mortgage holder relief from the stay.

While many associations hope that the bank's right to foreclose on a property will result in foreclosure and replacement of a non-paying owner with a new owner, the foreclosure sale is not always assured. Sometimes the bank uses the right to foreclose as a means of getting the debtor caught up on their delinquent mortgage payments. Other times, the bank's left hand

does not know what the right hand is doing. The bank's bankruptcy division will seek relief from the stay to foreclose, while the foreclosure division will not have any immediate plans to foreclose on the property.

At the conclusion of the bankruptcy the court will either discharge or dismiss the debtor's petition. If the debtor receives a discharge, the association must write off those pre-petition debts owed by the debtor. The exception to this is if there is a lien on the property. While the debtor will no longer be personally liable for the assessments, the lien may persist through the bankruptcy and be paid if the property is not foreclosed and the debtor subsequently sells the property. If the debtor's bankruptcy is dismissed by the court, then all assessments will again be collectible by the association.

If you have any questions about the Chapter 7 bankruptcy issues discussed above or how they may impact your community, please do not hesitate to contact any of our Community Association attorneys.