BANKRUPTCY PRIMER FOR NON-BANKRUPTCY ATTORNEYS

THREE TYPES OF CONSUMER BANKRUPTIES

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Chapter 7: Chapter 7 is a total liquidation. If the Debtor has non-exempt assets, then the Chapter 7 Trustee can sell the property to pay off creditors. After the Meeting of Creditors, the Chapter 7 Trustee will declare a case a "no-asset" or "asset" case. Most cases are "no asset" cases.

Chapter 13: This is a debt restructure where a Debtor proposes to pay back a certain amount of Debt subject to the requirements of the Bankruptcy Code. The Debtor files a Chapter 13 Plan, serving all creditors. Creditors can object to the proposed Plan. Chapter 13 contains considerable flexibility, particularly when a Debtor is facing foreclosure of real property. However, the Debtor must pay 1) all disposable income into the plan *and* 2) as much money as creditors would receive in a Chapter 7.

Example: *A Debtor owns $100,000.00 worth of real estate with a mortgage of $50,000.00. This results in $50,000.00 of equity. In Virginia, let us assume the Debtor uses $25,000.00 worth of his or her exemption to protect the non-exempt equity. In this case, in its most simplistic form, the Chapter 7 Trustee would yield $25,000.00 minus Trustee's commission.*

Instead, assume the Debtor files a Chapter 13. Because 11 U.S.C. 1325(a)(4) provides that property distributed on account of each allowed unsecured claim must be not less than the amount that would be paid on such claim if the estate were liquidated under Chapter 7, the result is the case could not be confirmed unless the Debtor pays at least $25,000.00 on all allowed unsecured claims. This is what is known as the *liquidation test*.

Chapter 12: Similar to Chapter 13 but reserved for family farmer's and fisherman.

Chapter 7 Process

1. Debtor(s) file petition and schedules under penalty of perjury.
2. Meeting of Creditors is conducted under penalty of perjury.
3. Chapter 7 Trustee determines whether the case is an asset or no asset case.
4. Discharge order typically generated within 60 days after the Meeting of Creditors, provided no objections.

Chapter 13 Process

1. Debtor(s) file Petition and schedules signed under penalty of perjury.
2. Debtor proposes Chapter 13 Plan for a period of 36-60 months.

3. Meeting of Creditors is conducted under penalty of perjury.
4. If no objections and the Plan meets the requirements of the Bankruptcy Code, the Plan is recommended by the Trustee for Confirmation subject to the Court's approval.

In each of the Chapters above, the case will have a "bar date", which is the deadline for a creditor to file a claim in a case. Each creditor will be served the Notice of Bankruptcy, which will provide notice of the bar date and brief instructions for filing a proof of claim against the Debtor. If a claim is not filed timely, the Creditor will not be paid. *See* Bankruptcy Rule 3001

What are the types of debt, and how are they treated?

1. Secured debt (Must be paid to release lien, but some flexibility.)
   - i Debt secured by property
   - ii Attachment and perfection
2. Priority Debt
   - i Typically, this is Debt under 11 U.S.C. 507 that is not discharged and must be paid.
   - ii Domestic support obligations
   - iii Certain tax obligations
   - iv In a Chapter 7, these debts get paid first in the event of liquidation.
   - v In Chapter 13, these debts are paid first.
3. Unsecured nonpriority debt: these are the Debtors who are last in line.
   - i Credit cards
   - ii Deficiencies
   - iii Medical bills

Most common Debtor misconceptions in bankruptcy:

1. Not all debt is subject to discharge!
   - i See 11 U.S.C. 523: student loans, certain taxes, and domestic support obligations, among other obligations outlined in the Code are not subject to discharge.
   - ii While the Bankruptcy Code can provide discharge of some taxes, it is best practice to review all tax returns or tax transcripts to determine whether the debt is actually dischargeable. There are some "grey" areas in the law concerning late filed returns.
   - iii All creditors must be listed. Debtors often inquire about leaving "some" creditors off because they want to keep a credit card, etc. This violates specific bankruptcy rules.

Trustee's Strong-Arm Powers

1. 11 U.S.C. § 544 gives the Trustee the power to avoid certain transfers of property. The Trustee has the power to step into the shoes of a harmed creditor to avoid the transfer and recover the transferred property for the benefit of unsecured creditors. Section 544 incorporates any transfer that is voidable under applicable state law.

2. 11 U.S.C. § 547 gives the Trustee the power to avoid preferences. This provision of the code was created to create fairness to creditors and give Trustees the ability to recover preferential transfers for the benefit of unsecured creditors.
    i. The general scenario where this arises is when a Debtor pays back a debt within 90 days of filing. If the creditor is an *insider* (friend or family), then the look-back period is one-year.
    ii. All transfers of this nature must be listed on the Statement of Financial Affairs.
3. 11 U.S.C. § 548 gives the Trustee the power to avoid fraudulent transfers. These are transfers made within two (2) years of the filing of the bankruptcy petition:
    i. Where the Debtor transferred property with intent hinder, delay or defraud any entity to which the Debtor was obligated; or
    ii. Received less than reasonably equivalent value in exchange; and
    iii. The Debtor was insolvent on the date the said transfer was made or because insolvent due to the said transfer.

Common Debtor pitfalls:

1. It is not uncommon for an individual to transfer property, whether real or personal, to a family member for less than fair market value. If the Debtor transfers property on the eve of bankruptcy or within the time period that triggers the Trustee's Strong-Arm powers, the Trustee may sue the recipient of the property to recover the transfer.
2. It is not uncommon for Debtors in bankruptcy to pay back friends or relatives (insiders) large sums of money. If an insider is repaid within one year of filing, the Trustee may seek to recover the value of the property transferred.

Bankruptcy Interplay with Domestic Relations

1. 11 U.S.C. 507(a)(1)(A) and (B) provide that "domestic support obligations" are priority debts.

    Section 101(14)(A) defines "domestic support obligation" as a debt that accrues before, on, or after the date of the order for relief in a [bankruptcy case] that is— (A) owed to or recoverable by (i) a . . . former spouse . . . ;

    a. 5 (B) in the nature of alimony, maintenance, or support . . . without regard to whether such debt is expressly so designated; (C) established . . . before, on, or after the date of the order for relief in a [bankruptcy case] by reason of applicable provisions of . . . (i) a separation agreement, divorce decree, or property settlement agreement; (ii) an order of a court of record; or (iii) a determination made in accordance with applicable nonbankruptcy law by a governmental unit…
2. 11 U.S.C. 523(a) contains the exceptions to discharge.
    a. 523(a)(5) addresses domestic support obligations ("DSOs")
    b. 523(a)(15) addresses property settlement claims.
3. Whether a particular debt is a DSO under 11 U.S.C. 523(a)(5) or 11 U.S.C. 523(a)(15) makes a difference in Chapter 13 cases.

a. 11 U.S.C. 1322(a)(2) provides that a chapter 13 plan must provide for full payment of priority claims under 507, which includes those under 523(a)(5), but not 523(a)(15).

4. Bottom line: The drafting of a final decree/property settlement agreement can have an enormous impact on dischargeability in a Chapter 13 case (but not Chapter 7). Counsel should be mindful of this when drafting said decrees/agreements.

Notable Western District of Virginia Opinions

***In re Weber* (15-70505)**

The Debtor and his wife, Ms. Profitt divorced on November 24, 2013. Paragraph 2 of the divorce decree provided:

That defendant has further indicated his desire to be awarded the parties' former marital residence located at 165 St. Augustine Road, Wirtz, Virginia 24184, the Court, finding that said property is burdened with debt in excess of its value, does further ADJUDGE, ORDER and DECREE that defendant shall have nine months from the date of the entry of this Order to refinance the current obligation secured by the aforesaid residence and that at the time of such refinance, plaintiff shall convey all of her right, title and interest in and to said property to defendant. In the event such refinance has not been accomplished, the parties shall list said property with a realtor at a price mutually agreed upon. In the event that the parties are unable to agree on a price, said price shall be determined by Richard Varney, a certified real estate appraiser, who has been agreed upon by the parties in open court to be an appropriate person to set said evaluation. In all events, the parties shall, unless otherwise agreed, be required, after said listing, to accept any offer of $225,000 or more once the same is listed for sale. Defendant shall have the sole and exclusive right to occupy said property and shall further maintain the property and pay all costs associated with his occupancy thereof, including, but not limited to, the mortgage, taxes, insurance and utilities.

The decree further stated:

UPON FURTHER CONSIDERATION WHEREOF, the Court having considered plaintiff's motion for an award of spousal support and finding that while she is in need of such support, that the defendant is totally incapable of paying such support given his income and the outstanding marital and business obligations assumed by him. Accordingly, the Court having further considered all of the factors set forth in Section 20-107.1 of the 1950 Code of Virginia, does ADJUDGE, ORDER and DECREE that the plaintiff's right to receive support from the defendant is reserved hereby for a period of six (6) years from the date of the entry of this Order

The Debtor objected to his wife's claim in a Chapter 13 case in the amount of $22,112.00 identified in the claim as "priority unsecured debt due to a domestic support obligation under 11

U.S.C. §507(a). His objection was based on several reasons, one being that the Claimant failed to cite any provision in the Divorce Decree that could be characterized as a "domestic support obligation".

The Court analyzed the definition of domestic support obligation contained in 11 U.S.C. §101(14A) and laid out the following four-factor test for determining whether an obligation is in the nature of alimony, maintenance, or support" and thus a "domestic support obligation:

1. the language and substance of the agreement;
2. the relative financial position of the parties when the entered the agreement;
3. the function of the obligation within the agreement; and;
4. evidence of overbearing at the time of the agreement.

The Court found that when applying the factors to the circumstances of the case, the Divorce Decree was not in the nature of alimony, maintenance, or support.

In re Bruce (Case No. 16-60489) 9/6/2016

Creditor-ex-spouse objected to confirmation of Debtor's plan that did not fully provide for a lump-sum home equity line payment arising out of a property settlement agreement claimed as a domestic support obligation. After the parties briefed the issue and the hearing was held, the Debtor then objected to the ex-spouse's proof of claim. The Debtor has the burden of proof as to compliance with Chapter 13 requirements, but the objecting party bears the burden of proof as to its objection. The Court denied confirmation of the amended plan as it did not provide for the creditor's priority claim for a domestic support obligation at all. To determine the amount of priority claim, the Court then turned to the Debtor's objection to the proof of claim. The burden shifted to the Debtor to present evidence to rebut the presumption of validity of the creditor's claim. After considering the *Webber* factors, the Court found that the creditor-ex-spouse did not meet her burden to demonstrate that, contrary to the plain language of divorce decree and property settlement agreement, the lump sum equity line payment was intended as a domestic support obligation under 11 U.S.C. § 507(a). The Court held that the obligation at issue was simply a lump sum division of marital debt and sustained the Debtor's objection.

Ethical Rules for Bankruptcy Practitioners

1. Bankruptcy Code and Rules
    a. 11 U.S.C. § 707(b)(4) – enforcement of the Federal Rules of Bankruptcy Procedure Rule 9011
    b. 11 U.S.C. §§526(a)(2) and 527(b) – debt relief agency's duties of diligence, competence, communication and candor

c. Federal Rule of Bankruptcy Procedure 1008 – petitions and schedules verified under penalty of perjury
d. Federal Rule of Bankruptcy Procedure 9011 – attorney's duty to conduct reasonable inquiry prior to filing and certification of same.

In re Robinson 198 B.R. 1017, 1024 (Banker.N.D.Ga.1996)

The duty of reasonable inquiry imposed upon an attorney by [Civil] Rule 11 and by virtue of the attorney's status as an officer of the Court owing a duty to the integrity of the system requires that the attorney (1) explain the requirement of full, complete, accurate and honest disclosure of all information required of a debtor; (2) *ask probing and pertinent questions designed to illicit full, complete, accurate and honest disclosure of all information required of a debtor*; (3) check the debtor's responses in the petition and Schedules to assure they are internally and externally consistent; (4) demand of the debtor full, complete, accurate disclosure of all information required before the attorney signs and files the petition; and (5) seek relief from the Court in the event that the attorney learns he or she may have been misled by a debtor." (emphasis added).

The second requirement places an affirmative duty on the attorney to take steps to ensure that the client is providing complete and accurate information. Merely relying on what the debtor provides is insufficient. The attorney must engage with the client and not just take a passive role; "attorneys must exercise not only supervision, but, more importantly, professional judgment that derives only through personal involvement in the case and evaluation of the client's needs. (emphasis added). *In re Robinson* 198 B.R. 1017, 1024 (Banker.N.D.Ga.1996)