Vermont Bar Association

2020 Mid-Year Meeting

Intersection of Bankruptcy and Other Practice Area

WEBINAR: June 10, 2020
12pm - 1:30pm

Faculty:

Heather Cooper, Esq.
Donald Hayes, Esq.
Samantha Henchen, Esq.

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Issue Spotting for Non-Bankruptcy Attorneys

PRESENTERS:
Heather Cooper, Esq.
Samantha Henchen, Esq.
Don Hayes, Esq.
Bankruptcy: Two Key Concepts:

- Fresh Start for the Debtors
- Fair and Equitable Distribution of Non-Exempt Assets to Creditors
Consumer Bankruptcy

- **Chapter 7**
  - Liquidation - all non-exempt property
  - Available to individuals and businesses - no debt limits
  - Must pass means test
  - Creditors paid dividend based on liquidated estate
  - Discharge

- **Chapter 13**
  - Personal reorganization - keep property
  - Individuals only - debt limits
  - 3 to 5 year payment plan
  - Creditors paid dividend based on retained liquidated estate (must be more than 7)
  - Cure defaults
  - Discharge
Automatic Stay

The Automatic Stay prohibits:

- Attempts to collect pre-petition debts
- Commencement or continuation of judicial or other proceedings to collect pre-petition debts (e.g., foreclosure, garnishment)
- Efforts to create, perfect or enforce liens on property of the estate or of the debtor, if relating to a pre-petition claim
- Efforts to take possession of or assume control of property of the estate (e.g., repossession of a car)
- Enforcement against the debtor or property of the estate of a pre-petition judgment
- Setoff of pre-petition debts
Corporate/Partnership Considerations
Why Would a Corporation/Business Seek Bankruptcy Relief?

- Pushed Against a Wall by a Creditor
- Recover Assets
- Terminate Contracts or leases
- Needs to re-align debt to get “priority” debt paid first: Not all Debts are Created Equal
  - Could be debt that has some considerations for the principals, such as personal guaranties or “trust taxes”
  - Creditor threatens ability to make pay roll obligations
  - No exemptions for corporations or LLCs.
- No longer viable or needs breathing room
  - Dictates which Chapter may be utilized
Which Chapter of Bankruptcy fits best?
Bankruptcy Considerations

The type of Company may dictate which Chapter is the right fit:

Sole proprietor: Owned by the individual. Thus, a personal bankruptcy under Chapter 7 or Chapter 13 would fit best. Chapter 11 may be an option if debt levels are too high.

LLC or Corporation: Separate “individual” in the eyes of the law. Chapter 11 or Chapter 7 would fit best, depending upon the Company.

- Reorganization vs. Liquidation: Chapter 7 Liquidates while Chapter 11 allows Debtor to Proceed under a Plan.
- Hinges on whether there is a realistic chance to turn things around.
- A Chapter 7 closes the business.
- Provides transparency.
- Can also hinge on whether the creditor body is “friendly” given the Plan hurdles in a Chapter 11.
- Chapter 11 has historically been frustrating for smaller businesses. The Small Business Reorganization Act of 2019 went into effect on February 20, 2020 with the stated purpose of streamlining the process by which small business debtors reorganize and rehabilitate their financial affairs.
- Chapter 7 is appropriate when the business does not have any substantial assets.
What if a principal files for Bankruptcy? What is the impact on the corporation or partnership?

It depends: What is the corporate form?

Are there personal guaranties?

Are there “trust taxes”?

May have the benefit of a co-debtor stay.
What if a Corporation or Partnership Files for Bankruptcy? What is the impact on officers/partners?

- It depends: What is the corporate form?
- Are there personal guaranties?
- Are there “trust taxes”?
- May have the benefit of a co-debtor stay.
- Alter Ego Claims/ Piercing the Corporate Veil
- Fraud / Preference Claims
- Loss of Investment
Family Law Considerations
Two main goals of a bankruptcy:

1. To give the debtor a fresh start; and
2. Ensure an equitable distribution is made to all creditors.

The debtor’s “fresh start” is always subordinate to the more compelling interests of the debtor’s family members to receive financial support.
Not All Debts are Created Equal - even in a separation or divorce

After separation or divorce debts are typically split into two categories:

- DSOs, or domestic support obligations; and
- Non-DSOs, or other separation debt (non-support obligations, property settlement, joint debt).

This is an extremely important distinction.
DSOs are defined under 11 U.S.C § 14A:

“[A] debt that accrues before, on, or after the date of the order for relief in a case under this title, including interest that accrues on that debt as provided under applicable nonbankruptcy law notwithstanding any other provision of this title, that is -

A) Owed to or recoverable by -
   i) a spouse, former spouse, or child of the debtor or such child’s parents, legal guardian, or responsible relative;
   or
   ii) a governmental unit.

B) In the nature of alimony, maintenance, or support (including assistance provided by a governmental unit) of such spouse, former spouse, or child of the debtor or such child’s parent, without regard to whether such debt is expressly so designated;

C) established or subject to establishment before, on, or after the date of the order for relief in a case under this title, 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; and

D) not assigned to a nongovernmental entity, unless that obligation is assigned voluntarily by the spouse, former spouse, child of the debtor, or such child’s parents, legal guardian, or responsible relative for the purpose of collecting the debt.”

In a nutshell: **DSOs are always in the nature of actual support.**
Non-DSOs (property settlement, joint debt, hold harmless) are defined under 11 U.S.C. § 523(15):

Debt owed “to a spouse, former spouse, or child of the debtor and not of the kind described in subparagraph (5) that is incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court of record, or a determination made in accordance with State or territorial law by governmental unit....” 11 U.S.C § 532(15).
Why is the distinction between a DSO and Non-DSO so important?

- **DSO (domestic support obligations):**
  - Chapter 7 - **not** dischargeable.
  - Chapter 13 - **not** dischargeable;
    - must be paid in full through plan (plan may provide for less than full payment if the debtor-spouse applies all non-disposable income to a 5-year plan, see section 11 U.S.C § 1322(a)(4));
    - all post-petition DSOs must remain current.

DSOs are given priority status. 11 U.S.C § 507(a)(1)(A).

- **Non-DSOs (property settlements, shared debts, and hold harmless agreements):**
  - Chapter 7 - **not** dischargeable
  - Chapter 13 - **dischargeable**, if debtor-spouse completes chapter 13 plan.

*High possibility this debt will be discharged in whole or in part.*
Factors the court will consider when determining whether obligation is a DSO:

Federal bankruptcy law, not state law, determines whether an obligation is a domestic support obligation. The court will consider the following factors:

(1) whether the obligation terminates on the death or remarriage of either spouse;

(2) the characterization of the payment in the decree and the context in which the disputed provisions appear;

(3) whether the payment appears to balance disparate income;

(4) whether the payment is due in a lump sum or over time;

(5) whether the payments are to be made directly to the former spouse or to a third party;

(6) whether the parties intended to create an obligation of support;

(7) whether an assumption of a debt or creation of an obligation has the effect of providing the support necessary to ensure that the daily needs of the former spouse and any children of the marriage are met; and

(8) whether an assumption of debt or creation of an obligation has the effect of providing the support necessary to ensure a home for the former spouse and any minor children.

In re Dudding, Case # 10-10557 (Bankr. D. Vt. Mar. 29, 2011)
What is there for a family law attorney to do?

**Always anticipate that the opposing spouse may file a Chapter 13 bankruptcy.**

1st: Determine what debts owed to your client under the settlement (including payments to third parties) would be characterized as a DSO or Non-DSO.

2nd: Try to find ways to avoid potential Non-DSOs or secure payment:

- payouts in exchange for property (for example, quitclaim deed exchanged at time of the payout).
- secure the Non-DSO (for example, a mortgage which creates a right to use specific property to satisfy the claim.) *Be sure there is adequate equity*;
- add language to show intent to pay support (see previous slide).
- **best option:** award property to your client in totality (ie, transfer of the house or retirement in lieu of an equalization payment).
Does the bankruptcy court have authority to modify a family court order?


→ The bankruptcy court, however, may void specific provisions in a state court orders that violate the automatic stay or the permanent injection of the bankruptcy court.
Real Estate Issues
Real estate issues and bankruptcy

- Common scenarios:
  - Property owner with judgment liens
  - Residential lease
  - Prospect of homeownership hampered by debt to income
  - Investment property underwater
  - Estate planning - protect homestead from creditors
Property of the bankruptcy estate includes all legal and equitable interest

“Automatic Stay” protects debtor and debtor’s property

Avoidance powers of trustee

Ability to modify liens under certain circumstances
Scenario 1: Judgment Liens

- Client would like to sell or refinance, but judgment liens recorded
- Options:
  - Pay off judgment liens either at closing or before
  - Wait statutory period (8 years unless renewed)
**Scenario 1: Judgment Liens**

- **How can a bankruptcy filing help?**
  - **Two Options:**
    - The homestead, personal property, or wildcard exemptions may allow debtor to avoid a lien to the extent it impairs an exemption.
      - 11 U.S.C § 522(f)
        - Judicial Liens
        - Non-possessory, non-PMSI liens in household furnishings, goods, wearing apparel, appliances, animals, crops, musical instruments, held primarily for household use of debtor or dependents, tools of the trade, and professional prescribed health aids of debtor or dependent.
    - The lien was filed within 90 days of filing for relief
      - 11 U.S.C. § 547
      - Trustee can avoid transfers (including liens) which occur within preference period AND result in creditor receiving more from the transfer than the creditor would have received in hypothetical Chapter 7 liquidation and where the debtor is insolvent.
      - BUT - pay attention to exceptions and defenses (§ 547(c)). For example, new value, contemporaneous exchange, ordinary course, creates security interest in property acquired by the debtor, etc.
Scenario 1: Judgment Liens - Impairment

- How do we determine whether a judgment lien impairs an exemption?
  - Example: Debtor owns home which is used as her primary residence valued at $200,000.00 with a mortgage of $150,000.00. Debtor identifies a judgment lien to Credit Card Company from a collection action. Judgment was final on April 30, 2019 in the amount of $11,230.00.
    - Under 522(f) the “debtor may avoid the filing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled to” under applicable exemptions.
    - Add the lien being tested for avoidance of $11,230.00 to the other exiting liens $150,000.00, then add the available exemption of $125,000.00 for a total of $286,230.00.
    - Subtract the value of the property of $200,000.00 and the extent of the impairment is $86,230.00 meaning the entire lien is avoidable.
  - Once order granted, it with certification from Trustee can be recorded in land records.
Scenario 1: Judgment Liens - Avoidance

How do we determine whether a lien is avoidable?

Example: Debtor owns home which is used as her primary residence valued at $200,000.00 with a mortgage of $150,000.00. Debtor identifies a judgment lien to Credit Card Company from a collection action recorded May 15, 2020. Judgment was final on April 30, 2020 in the amount of $11,230.00.

- Section 547 of the Code specifies a “preference period” of 90-days prior to filing where the transfer for the benefit of a creditor, on account of an antecedent debt, made while debtor was insolvent (code presumes debtor was insolvent 90-days prior), that enables the creditor to get more.

- If the Debtor filed June 10, 2020 - the judgment lien as recorded on May 15, 2020 would be avoidable without having to show that it impairs an exemption. Most creditors will agree to discharge without further proceedings.
Scenario 2: Residential Rent Arrears

- Example: Debtor’s income was reduced due to COVID-19. Debtor is facing eviction for non-payment.
  - Landlord has obtained a writ of possession.
    - Section 362(b)(22) indicates that the stay does not operate where the landlord obtained a writ of possession
      - Under VT. LBR 4001-2 Debtor would need to deposit with Bankruptcy Court the amount that would have come due within 30 days after the filing date (usually within 3 business days of filing)
      - Then the Debtor will need to cure the entire default within 30 days from the date of filing
      - Debtor needs to file certification
Scenario 2: Residential Rent Arrears

- Example: Debtor’s income was reduced due to COVID-19. Debtor is facing eviction for non-payment.
  - Landlord has not obtained a writ of possession.
    - Automatic stay goes into effect upon filing - stops eviction without having to pay deposits (362(b)(22) only applies where landlord has obtained writ)
    - Unexpired lease that has been terminated under state law due to non-payment can cured in a Chapter 13 - the arrearage can be paid over time and the lease can be reinstated
      - Time to cure is limited - usually no more than 6 months unless by agreement
Scenario 3: Dream of Homeownership

- Example: Debtor has expressed desire to purchase a home; however, credit history includes many derogatories. Debtor could pay off a significant number of creditors over a 2- to 4-year period but would impose a hardship.
  - Debtor could seek out debt consolidation program or attempt to negotiate settlements with creditors
    - Will continue to negatively impact credit
    - Will divert funds from savings that could be used for down payment
    - Sensitive to changes in household finances
  - Debtor could contemplate bankruptcy filing
Scenario 3: Dream of Homeownership

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<thead>
<tr>
<th>Loan Type</th>
<th>Chapter 7</th>
<th>Chapter 13</th>
</tr>
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<tbody>
<tr>
<td>Conventional</td>
<td>4 years</td>
<td>2 years from discharge date; 4 years from dismissal date</td>
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<tr>
<td>FHA</td>
<td>2 years</td>
<td>1 year</td>
</tr>
<tr>
<td>USDA</td>
<td>3 years</td>
<td>1 year</td>
</tr>
<tr>
<td>VA</td>
<td>2 years</td>
<td>1 year</td>
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### Scenario 3: Dream of Homeownership

<table>
<thead>
<tr>
<th>Loan Type</th>
<th>Foreclosure Waiting Period</th>
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</thead>
<tbody>
<tr>
<td>Conventional</td>
<td>2 years from discharge date; 4 years from dismissal date; 7 years in all other cases</td>
</tr>
<tr>
<td>FHA</td>
<td>3 years</td>
</tr>
<tr>
<td>USDA</td>
<td>3 years</td>
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