

The Spokane County Bar Association

presents

The Ins & Outs of Bankruptcy CLE

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An SCBA CLE Passport Qualified Seminar for the Video Conference

Representing Creditors: Basic Considerations and Some Potential Issues Raised by COVID-19

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1. Getting Started

What do you do when one of your clients calls you and says they got a notice of bankruptcy filing from one of their creditors?

A good start is to gather all relevant documents from the client, including any contracts, invoices, security agreements, or deeds. These will likely be helpful as you plan a path forward. If you plan to represent the creditor in relation to the bankruptcy, great and best of luck on behalf of your client. It is not, however, shameful or disfavored if you recommend to your client that you involve bankruptcy counsel in the process, as while it is not rocket science, it also isn't always intuitive and failing to meet certain deadlines can be detrimental to your clients' rights.

Regardless of which approach you recommend for your client, make sure that you are familiar with the general process and deadlines.

2. Creditor Status- Secured versus Unsecured Creditors:

Is the creditor's claim/interest secured by some collateral as of the date of filing? If so, is the security interest perfected as of the date of filing?

If the answer is no, you likely represent an unsecured creditor.

If the answer is yes, the claim is likely secured, so long as it was properly perfected prior to the bankruptcy filing.

Examples include mortgages and deeds secured against real property, vehicle loans secured by the vehicle itself, and personal property secured by UCC-1 Financing Statements.

This is important to assess for your creditor client because the bankruptcy discharge is usually only in relation to the personal liability of the debtor, not to any perfected lien or security interest. As a result, the creditor cannot take any action against the debtor to collect a discharged debt *as the personal liability of the debtor*.

Valid and perfected liens generally survive the bankruptcy intact. The result is that if a debtor subsequently defaults again or fails to make the required payments on the underlying obligation, the secured creditor can typically foreclose on the lien or security interest. So if the debtor wants to retain the secured property, the debtor must continue to pay even discharged debts. The creditor's recovery, however, is limited to recovery of the collateral.

3. Proof of Claim

Read the initial bankruptcy notice that comes a few days after the case is filed. It contains important information:

- i. The date of the filing;
- ii. The type (chapter) of bankruptcy case;
- iii. The date, time, and place of the 341 creditors' meeting;
- iv. The deadline for objecting to the debtor's discharge or to the discharge-ability; and
- v. A notice about filing a proof of claim.

The type of case will govern when, and even whether, a claim is filed. The type of debt, and whether it is secured by a primary residence, will govern what documentation or supplements should be filed with a proof of claim form.

Those forms are available through the Eastern District Bankruptcy Court website.

4. Automatic Stay and Exceptions

The stay goes into effect from the exact moment the petition is filed. No order is necessary to trigger it. The automatic stay is intentionally broad and applies to all actions to collect debts, perfect liens, attach property, repossess property, setoff accounts, etc.

Generally, any collection action taken after the filing of the case is a violation of the automatic stay. As a result, heed all notices that a bankruptcy petition has been filed, and check PACER to confirm a filing.

Even if you have not received notice, checking PACER for a filing before commencing or taking a significant action (demand letter, lawsuit, foreclosure, repossession, etc.) is prudent.

A debtor is tasked with informing the Spokane County Superior Court (local rule 12) within 1 judicial business day if there is ongoing state court litigation. Often I find that I end up doing this on behalf of the creditor.

The automatic bankruptcy stay applies until one of several events occur; the bankruptcy court grants relief from the automatic bankruptcy stay to allow a creditor to take specified action (the stay remains effective for all other parties); the debtors in an individual Chapter Seven or Chapters Nine, Eleven, Twelve or Thirteen have received a discharge; the bankruptcy case is closed; or the bankruptcy case is dismissed.

The automatic stay is the great equalizer: it gives the debtor relief and levels the playing field among the creditors. The "race to the courthouse" ends.

The exceptions listed in the statute are narrow but important. For example, the automatic stay does not prohibit the act of a lessor to the debtor under a lease of non-residential real property that has terminated by the expiration of the stated term of the lease before the commencement of or during a case under this title to obtain possession of such property (11 U.S.C. § 362(b)(10)). Neither does it apply to residential tenancies when a lessor has obtained a judgment for possession of the property against the debtor prior to the bankruptcy filing.

Sanctions can follow if you violate the automatic stay, so be careful.

The Good News for Creditors:

Reaffirmation Agreements:

These are written agreements whereby the debtor agrees that although the debtor is not required to do so, there is some benefit that the debtor wants that would be provided if the debtor agreed not to discharge the debt. Commonly seen with vehicles when they are necessary for the debtor's use or for tire (Les Schwab does these a bunch). If the debtor doesn't have counsel involved, a hearing is typically required.

The reaffirmation agreement must be signed by the debtor and the lender and filed with the court within 60 days after the first date set for the creditors' meeting. The agreement must be on the approved form and must include copies of the note and security documents establishing the lien on the collateral.

For personal property collateral (e.g., car loans), the failure to comply with the requirements could result in the issuance of an order finding that the debtor has complied with all requirements under the statute and that the lender cannot repossess the personal property if the debtor continues the regular payments.

Objections to Discharge:

Section 523 of the Bankruptcy Code provides a litany of debts that are not dischargeable (even if the debtor gets a general discharge in the case), but, in most cases, a creditor must affirmatively object to the discharge of its debt by filing an adversary proceeding (litigation within the bankruptcy case).

Many of the grounds for such objection stem from fraud or dishonesty on the part of the debtor. The rub is that in order to proceed on these, you need to file an adversary proceeding to get that determination. Lawsuit within the bankruptcy court. Some courts prefer that you just ask for relief from stay so you can continue in state court, but that is not typically the case in our district.

The deadline for the filing objections to the discharge of a particular debt is about 90 days after the creditors' meeting and will be listed in the initial notice of the filing of the bankruptcy case. If the complaint is not filed within the time period established (which can be extended by the court), the debt is likely to be discharged. Section 727 of the Bankruptcy Code provides that the entire discharge of a debtor can be denied under certain circumstances. These claims are commonly brought by the U.S. Trustee, but can also be claimed by creditors in certain circumstances.

Creditors' Committees:

In Chapter 11 case, the U.S. Trustee can seek to appoint a creditor. In a Chapter 11 case, the U.S. Trustee can seek to appoint a creditors committee of unsecured creditors, usually who represent the seven (7) largest claims in that group. That group has the ability to obtain counsel and to investigate the matter and work with the Debtor in Possession or the Trustee in matters related to the case.

The Tough News for Creditors

Sales Free and Clear:

Section 363(f) allows the trustee to sell property free and clear of liens under many circumstances if the amount of all liens on the property is less than the value of the property.

Lien Stripping/Cramdown:

One of the essential elements of reorganization cases under Chapter 11 and 13 is the debtor's right to modify the terms of the loan with the creditor: to adjust the interest rate, the term, the payment amount, and/or the principal amount.

These proposed modifications are subject to court approval during the plan confirmation process and cannot be approved over the creditor's objection, unless certain requirements and standards are met. In Chapter 13 cases and individual Chapter 11 cases (outside of some limited circumstances in a small business debtor Subchapter V case), the terms of a home mortgage loan cannot be modified without the consent of the lender, if the only collateral for the loan is the debtor's principal residence.

Lien Stripping applies to Chapter 13 cases where creditors have multiple liens on the same property, typically on a home mortgage. If the senior creditor holds a lien against the full amount of its loan/mortgage and the value of the house declines, a circumstance can exist in which any junior creditor may, based on the value of the real property, become "wholly unsecured." In that circumstance, the debtor can move the court to "strip" the junior lien. If that occurs the junior lienholder's claim becomes unsecured.

Avoidance and Preferential Transfer Issues

Generally speaking, a preference is payment or transfer of the bankruptcy debtor's property (including the giving of a lien or deed of trust) made with respect to an existing debt within 90 days before a bankruptcy filing.

One of the powers given to bankruptcy trustees is the ability to file lawsuits against creditors who received payments or transfers from debtors before bankruptcy filings.

Generally speaking, any payment made to a creditor by a bankruptcy debtor during the 90-day period prior to the debtor's bankruptcy filing may be avoided and clawed back for the benefit of the bankruptcy estate. Preference actions typically occur in commercial cases as to revolving credit relationships. They are meant to avoid the undesirable circumstance where a debtor, recognizing his financial troubles, siphons off all of his assets to his "preferred" creditors prior to filing bankruptcy to the exclusion of his seemingly less-preferred creditors.

Despite that rationale, no creditor likes to end up as a defendant in a preference lawsuit. Fortunately, there are defenses to many such claims. However, a creditor's actions prior to a bankruptcy filing can impact whether a creditor may rely upon those defenses. One such defense is called the "ordinary course of business defense," and it prevents a trustee from avoiding prepetition payments received by a creditor when those payments were made pursuant to the normal business relations between the creditor and the prepetition bankruptcy debtor.

When analyzing the ordinary course, defense courts look to whether any unusual collection or payment activity occurred during the 90-day period before bankruptcy as compared to the historical business relations between the parties.

Practice Tip – especially following the Covid-19 Pandemic: Creditors can, therefore, preclude their ability to protect preference payments by unduly pressuring a debtor when they get into financial distress or by changing credit terms during the 90-day period. The more a creditor can interact with a troubled debtor as they did prior to the advent of the debtor's financial issues, the better chance the creditor has of protecting any payments they receive during the preference period. This is something to keep in mind if things go south for your borrowers in the wake of the COVID-19 pandemic.

Even if you know the debtor intends to file for bankruptcy, take the payment. Defenses are often available, and cases often settle for less than 100 percent.

COVID-19 Impacts:

Landlord Tenant Law – Residential and Commercial.

Mortgage foreclosures.

Hard Money Lenders.

Vehicle claims.

Inability to file Chapter 13 if not employed with income.

Medical bills in the absence of health insurance.

Dissolutions – fights over property settlements.

Business ongoing operations.

Retailers.

Bars and Restaurants.

The arts/musicians.