MODEL ANSWER

Course Number S445

Course Name Bankruptcy

Professor Michael Fallon

An individual who seeks the counsel of a bankruptcy attorney is an individual overwhelmed with debt with no place to turn, who needs to understand both the benefits and the consequences of seeking the protection of the bankruptcy court. Jonathan is such an individual.

Jonathan may elect to file for protection under Chapter 7 of the bankruptcy Code, often referred to as a “straight” or “liquidating” bankruptcy, wherein Jonathan would be requesting that the court enter an order that relieves Jonathan of his debt (the “Chapter 7 Discharge of Debtor”). He may choose instead to reorganize his financial affairs under the protection of the Bankruptcy Court through a chapter 13 filing. The process of determining the relief best suited for Jonathan begins with an analysis of the consequences to Jonathan should he file for relief under Chapter 7.

<u>Property of the Bankruptcy Estate</u>

The commencement of a case under the Bankruptcy Code creates an estate that, with few exceptions not applicable here, is compromised of all property owned by Jonathan: his home in Santa Rosa, cash on hand, money on deposit with North Coast Bank, his furniture, clothing, jewelry, etc. The individual appointed by the court to administer these assets, the chapter 7 trustee, will determine which of these assets can be sold to pay the claims of creditors and which assets must be abandoned.

The trustee will first look to see if the assets have a value, after subtracting any debt that might be secured by the assets, that would upon liquidation allow for a meaningful distribution to the unsecured creditors, and then will look to see if the debtor is able to “exempt” these assets, that is protect the assets from sale by the trustee. Here, Jonathan does not have any equity in his home as the first and second deeds of trust that secure the payment of the debt to the Bank of America exceed the value of the home; he also does not have any equity in the automobile that was recently repossessed so we may conclude that neither of those assets would be lost in a chapter 7 filing. Jonathan’s remaining assets are not collateral for any loans and thus, unless the assets can be protected by operation of law, the assets may be sold by the trustee to pay the claims of Jonathan’s creditors.

Exempt Property

The Bankruptcy Code provides at Section 522 that Jonathan may “exempt” or protect certain property from sale by a trustee; pursuant to Section 522 (b) the States may choose the law that an individual my use to “exempt” property - the Federal Exemptions under Section 522 or applicable State law. Because Jonathan is a resident of California, Jonathan must look to California law to protect his property as California has “opted out” of the Federal system.

Jonathan has two choices, both found in the California Code of Civil Procedure. CCP §704, et seq, that is applicable in either state or bankruptcy proceedings, is most often used by debtors to protect the equity in their home because that allows a debtor like Jonathan to protect as much as $100,000 of equity. However, where there is no equity in a home, as is the case here, an individual may use an alternate body of law, CCP §703.140, et seq to protect property Jonathan would not be able to protect if he utilized CCP §740.

Jonathan does not need to be concerned with losing his household goods and furniture, clothing, etc because those assets are protected by CCP §703.140(b)(3). Jonathan should also not be concerned with losing his jewelry because that is protected by CCP §§703.140(b)(4) and (b)(5) (the "grubstake" exemption that allows for the protection of property up to a value of $23,000). The life insurance policy is protected by CCP §§703.140(b)(8) and (b)(5); the retirement account is protected by CCP §703,140(b)(10)(E). While Jonathan can protect some of his interest in MaterCraft Enterprises (CCP §703.140(b)(5)) and some of his personal injury claim (CCP §703.140(b)(11)(D)), both of those assets may be liquidated by a trustee as can the projected and unprotected income tax refund.

To this point Jonathan has only had to consider the partial loss of the assets to decide if a chapter 7 filing is appropriate, but other factors need to be considered.

<u>The Trustee's Avoiding Powers</u>

The relief afforded to those who need the protection of a bankruptcy filing is certainly the most significant purpose of the Bankruptcy Laws, but it is not the only purpose: parity amongst unsecured creditors is another and so the Congress, in drafting the Bankruptcy Code, gave to the chapter 7 trustee the power to "avoid" certain kinds of transactions between the debtor and third parties - avoiding the preferential treatment of one creditor over other creditors is one, avoiding transfers of property for less than fair value is another (§§547 and 548).

In May and June of this year Jonathan made payments to Bank of American on those obligations that are secured by his family home. In February of this year, Jonathan paid his sister $1,750 to satisfy an outstanding loan to her. If the chapter 7 trustee can establish that the transfers to Bank of America were made on or within 90 days of the filing of the bankruptcy petition on account of an antecedent obligation, made while Jonathan was insolvent, that allowed the bank to receive more than it would have received had the money be distributed equally amongst the creditors, the trustee might be able to "avoid" or recover those payments for the benefit of all creditors (§ 547(b)). While the payment to Jonathan's sister was outside the 90 day window, that payment may be recoverable because it was within the expanded window of one year for payments to insiders (§101(31), 547(b)(4)(B)). However, the fact the trustee may be able to establish each of these elements does not necessarily mean the trustee will take the action required to avoid the transfers. For example, although the payments to the first mortgage arguably were made on account of the unsecured portion of the loan, it is not probable the trustee would pursue such recovery because of the relatively small amount involved and because the bank would likely press its defense that the payments were made in the ordinary course of business (§ 547(c)(2)). The payments to the bank on the second mortgage and the payment to the sister, while certainly avoidable, would not likely be pursued because the cost of recovery would far out weigh the benefit to the unsecured creditors[1].

The payments to the long term care facility where Jonathan's mother resides is an issue, not because Jonathan preferred the facility over other creditors, but because the payments might be seen as a transfer of property without Jonathan receiving consideration in return for the payments (§548)(future consideration is not sufficient). The payments could also be interpreted

[1] The trustee would probably reach the same conclusion when considering whether to pursue the money seized by the Bank of Alameda in June.

as gifts to the mother which clearly are not supported by consideration. In either case, Jonathan's mother would be impacted either because the trustee would have a claim against St. Margaret's or a claim against his mother (§548)[2].

The sale of the Buick just shortly before the filing may be an issue for two reasons, first, the trustee is going to look to see if the $15,000 Jonathan received for the vehicle was a fair price, and second, the trustee is going to want to know what happened to the $15,000. From all appearances the price received for the vehicle appears reasonable so that is not likely to be an issue; but what of the fact the sale occurred within days of the filing? There is no question that debtors may engage in planning for their filing by converting "non-exempt" assets into "exempt" assets the trustee cannot reach (*In re Hanson*, but see *In re Tveton*), but the conduct begs several questions - did Jonathan go too far when he sold the $15,000 asset that could not be protected? What did he do with the sale proceeds? The latter question is answered by looking to the payments to St Margaret's; the former is not so easily answered.

<u>Jonathan's Home Has a Market Value Less than the First Mortgage</u>

Jonathan's home has a fair market value of $395,000. There is a first mortgage of $425,000 and second mortgage of $75,000. Bankruptcy Code Section 506 provides that an allowed claim of a creditor secured by a lien on property is a secured claim to the extent of the value of the collateral. In this case, there is no value to the collateral that secures the second mortgage because there is not enough value in the home to fully secure the first mortgage held

[2] It is also possible, although not probable, that a trustee could bring an action under §727(a)(2) to deny Jonathan a discharge ("The Court shall grant a discharge unless ...(2) the debtor, with the intent to hinder delay or defraud a creditor or an officer of the estate ... has transferred, removed, destroyed, mutilated, or concealed ... (A) property of the estate, within one year before the date of the petition." (See *In re Tveten*))

by the same lender.[3] However, because the second mortgage is secured by only the principal residence there is nothing that can be done to avoid or remove the deed of trust in a chapter 7 filing (*Dewsnup v. Timm).* A chapter 13 filing is another matter: Pursuant to Sections 506 and 1322, Jonathan could propose a plan that provides that the second deed of trust would be avoided either by motion or adversary proceeding and paid as a general unsecured claim.

The Repossessed Vehicle

The vehicle that was repossessed shortly before the filing is nevertheless property of the estate, subject to the lien of the Exchange Bank, and will be property of the estate until such time as the Exchange Bank liquidates its collateral (*In re Whiting Pools*). Assuming the bankruptcy petition is filed before the liquidation, the Exchange Bank can be compelled to turnover the vehicle to Jonathan who in turn will be required to make payment to the Exchange Bank to adequately protect the bank's interest in the vehicle (*Whiting Pools*, see also Section 363).

Conclusion

Unquestionably a chapter 7 filing would give Jonathan relief - but at a price: Jonathan will have to deal with the preferential payments to his sister, the pre-petition planning that involved the sale of his automobile on the eve of the filing and the pre-payment of his mother's care. Importantly, the relief Jonathan would be getting would be limited to the discharge of only his unsecured debt as the tax liability would not be dischargeable (§ 523(a)(1)), the spousal support would still be owing (§ 523(a)(5)) and the second deed of trust would continue as a lien on his home (*Desnup v. Timm*). The chapter 13 on the other hand would give to Jonathan a

[3] It should be noted that while the first mortgage may not be fully secured, the Code does not allow a debtor to modify the rights of a lender that is secured by the principal residence of the debtor. See Section 1322(b)(2).

means to:

1. Establish a payment schedule for the delinquent spousal support;

2. Establish a payment schedule for the delinquent tax liability;

3 Cure the default to the first mortgage;

4. Remove the second mortgage;

5. Recover his repossessed vehicle;

6. Diffuse to a large extent an inquiry into the payment to his sister;

7. Eliminate any action to recover the payments to St. Margaret's.

It is true that a first look at Jonathan's income and expenses raises feasability issues (§ 1325). However, Jonathan should be able to show that with the payment to the second mortgage going away by virtue of the lien avoidance, and the likely reduction of the payment on the Exchange Bank obligation to the value of the collateral (§§ 506 and 1322), his chapter 13 plan should be confirmed[4].

0
00

[4] It is possible that either a creditor or the trustee could raise the issue of the debtor's "good faith" in proceeding under chapter 13, an element that must be established as a condition to confirmation (§1325(a)(3)), it is not likely that such an argument would carry the day because Jonathan's conduct was consistent with 9th circuit case authority.