

## Homeowner Bankruptcy

### The Five Things Your Board Must Know When an Owner in Your Community Files Bankruptcy

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Every owner in a community association is obligated to pay assessments. Inevitably, some owners fall behind in their payments. When hit with dire circumstances and mounting debt, these owners may resort to bankruptcy protection for debt relief. It is critical for community association boards of directors and community managers to understand the impact of an owner's bankruptcy filing on the association.

Here are the five basic things every director and manager should know when an owner files bankruptcy:



#### 1. Stop All Collections Activity

First and foremost, every director and manager should know that all association collection activity against a past due owner in bankruptcy must cease immediately.

The federal Bankruptcy Code at 11 U.S.C. § 362 imposes a stay on all collections activity when a debtor files bankruptcy. This means that all that debtor's creditors, which includes homeowner and condominium associations, must cease all collections activity for that debtor. The Bankruptcy Code defines "collections activity" broadly.

For community associations, prohibited collection activity includes, for example:

- Calling a delinquent owner
- Sending past due notices
- Filing liens
- Initiating or continuing pending law suits
- Initiating or continuing pending garnishment actions
- Taking any steps towards foreclosing on the property
- Suspending owner rights to access amenities in the community, and
- Any other efforts to collect assessments or fines due.

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Any continued collections activity after an owner files bankruptcy is considered a violation of the automatic stay. If an association violates the automatic stay by engaging in any collections activity for an owner in bankruptcy, the association can be subject to serious penalties, including severe monetary sanctions by the bankruptcy court.

## 2. Split Account Ledger

When an owner files a bankruptcy case and the required bankruptcy petition, it is also critical for the association to split the owner's account ledger into pre-bankruptcy and post-bankruptcy amounts due. An owner's debt is then divided into two categories: pre-petition debt and post-petition debt.

### Pre-Petition Debt

All amounts owed by the owner as of the date the owner files the bankruptcy petition are considered pre-petition debt and will be administered by the bankruptcy court. When an owner files bankruptcy, the owner's case is assigned to a judge and a bankruptcy Trustee immediately upon filing. The Trustee's role and responsibilities vary depending upon which chapter of bankruptcy is filed. However, regardless of which chapter is filed, the Trustee plays the role of a neutral third party who is responsible for administering and overseeing the bankruptcy case.

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### Post-Petition Debt

All amounts incurred by the owner after the date the bankruptcy petition is filed are considered post-petition debt. While there is a requirement that an owner in bankruptcy not incur new debt without requesting and receiving bankruptcy court approval, it is common that an owner will have ongoing, long-term payment obligations, such as association assessments, that will come due during the pendency of the bankruptcy case. These ongoing obligations are also considered post-petition debt.

In some jurisdictions, both pre-petition and post-petition payments to secured, long-term creditors are paid to and administered by the Trustee. However, in Georgia, only pre-petition debt is paid through the bankruptcy case. Unfortunately, if an owner does not pay post-petition assessments, Georgia associations are limited in collection of these amounts because they cannot engage in any collections activity that would violate the automatic stay.

## 3. Chapter 7 — Liquidation Bankruptcy

A Chapter 7 Bankruptcy is a liquidation of an owner's debt. Generally, Chapter 7 cases are better for owners and worse for associations because the owner can often discharge all pre-petition debt without having to pay any of the past due amounts to the association. However, some owners who file Chapter 7 have assets, and, in those cases, the Trustee will sell the assets and use it to pay the owner's debts.

### Asset Sale

In most cases, an owner has the option of retaining his or her home so long as the mortgage is current and there is little or no equity in the home. However, if an owner has substantial equity in the home, the Chapter 7 Trustee will likely pursue selling the home in order to pay off other debts of the owner. Many owners do not realize that the Trustee may seize and sell their home in a Chapter 7 Bankruptcy.

### Attorney Entry of Appearance

When an owner files Chapter 7 bankruptcy, we recommend the association simply keep an eye on the bankruptcy case and monitor for updates. The best way to do that is have NowackHoward file an entry of appearance as attorney for the association and we will then receive notices of activity in the case. Otherwise, there is typically not much more an association can do to protect itself in an owner's Chapter 7 bankruptcy case.

### Owner Obligations

While a Chapter 7 Bankruptcy may seem like an “easy out” for homeowners who take on too much debt, there is a means test to qualify for a Chapter 7 bankruptcy, so not everyone is eligible. If the Court determines a debtor has too many assets to qualify for Chapter 7, the bankruptcy case will be dismissed or converted to a different chapter of bankruptcy (either Chapter 13 or even Chapter 11).

Debtors in Chapter 7 bankruptcy must comply strictly with the bankruptcy rules while their case is pending. These rules include paying required filing fees and submitting all required documentation. If a debtor fails to keep up with these obligations, the Court may dismiss the bankruptcy case, in which event the association can proceed to collect the debts as if no bankruptcy was ever filed.

### Discharge

If an owner successfully completes a Chapter 7 Bankruptcy, the owner will receive a discharge of all pre-petition debt, and the Trustee will abandon any remaining assets. Chapter 7 cases are often resolved quickly, within three to four months. Once the discharge is granted, the association cannot pursue any pre-petition debt, but the association is free to pursue any post-petition debt due from the owner.

Once a debtor receives discharge of their debts under Chapter 7, they are not eligible for another Chapter 7 discharge for eight years.

## 4. Chapter 13 — Reorganization Bankruptcy

A Chapter 13 Bankruptcy is a reorganization of an owner's debts. In most cases, an owner files Chapter 13 in order to retain his or her home. In a Chapter 13 bankruptcy case, the association may be repaid the bankrupt owner's past due assessments in full, so it is critical that the association is aware of court deadlines and creditor obligations.

### Repayment Plan

In a Chapter 13, the owner must submit extensive information to the bankruptcy court, including a comprehensive list of creditors, estimates of debt owed, employment history, sources and amounts of past and current income, prior year tax returns, prior bankruptcy filing history, and potential litigation or unresolved claims. The owner must also submit a proposed Chapter 13 debt repayment plan (the “Plan”) to lay out the terms the owner proposes to repay each debt.

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### Plan Approval

The Bankruptcy Code lays out specific rules regarding which debts must be paid from the Plan. Each Chapter 13 Plan must be approved, or confirmed, by the court. The Trustee and all creditors are given an opportunity to review the proposed Plan. Associations should review each bankrupt owner's plan to ensure the full amount of pre-petition debt is scheduled to be repaid. If the total past due amount is not scheduled, the association has the right to file an objection to the Plan. Debtors often file multiple amended Plans before one is proposed that is acceptable to the Chapter 13 Trustee, the creditors and the court.

### Proof of Claim

Every association must file a Proof of Claim in each homeowner's Chapter 13 case in order to ensure that it receives payment for any pre-petition debt the bankrupt owner owes. NowackHoward can file both an Entry of Appearance and the required Proof of Claim for the association to ensure receipt of notices in the case and repayment of the owner's pre-petition debt to the association. Even if an owner has already included the debt due the association in the Plan, the association must still file a Proof of Claim because the Chapter 13 Trustee disburses all payments pursuant to the filed creditor Proofs of Claim, not the Plan.

The Proof of Claim must state the amount of pre-petition debt due from the owner to the association and include an itemized breakdown of the balance due. The Proof of Claim also establishes the association's secured creditor status in the bankruptcy case. Secured creditors have higher priority for repayment than unsecured creditors.

While all interested parties, including the owner and the Chapter 13 Trustee, have the right to review the Proof of Claim and object to it, it is generally made part of the repayment plan for the owner. Once payments under the Plan begin, the Chapter 13 Trustee will disburse the owner's agreed upon payments under the Plan to the creditors. The Chapter 13 Trustee also determines the order in which the creditor claims are paid and the amount that is paid towards each claim per month.

### **Discharge**

A typical Chapter 13 Bankruptcy lasts approximately five years, so much longer than the typical Chapter 7 case. If the owner successfully completes a Chapter 13 Bankruptcy, the owner will receive a discharge. Once a discharge is granted, all secured pre-petition debt should be paid and all non-secured debt is discharged.

However, if the owner fails to comply with the bankruptcy requirements during the pendency of the case, the Chapter 13 Bankruptcy will be dismissed, and no discharge granted. When a bankruptcy case ends in a dismissal, the association can proceed as if the bankruptcy was never filed while keeping any payments that it has already received from the Chapter 13 Trustee while the case was active.

## **5. Manage Post-Petition Debt**

Even though the Bankruptcy Code prohibits an owner in bankruptcy from incurring new debt, owners often fall behind on post-petition assessments while their bankruptcy case is pending. Owners may also violate the covenants during their bankruptcy case and become subject to post-petition fines. Because of the automatic stay against all collection activity, the association should seek NowackHoward's legal counsel before pursuing collection of any post-petition debt. The best course for post-petition amounts due will depend on the owner's unique financial situation, the chapter of bankruptcy filed, the amounts past due, and the association's goals.

The NowackHoward Collection Team generally recommends first notifying the owner that post-petition amounts have come due. However, this must be done in a manner that

complies with the Bankruptcy Code and does not violate the automatic bankruptcy stay. There is a thin line between a communication that notifies the owner of the debt and a communication that can be construed as an attempt to collect on a debt. We encourage directors and managers to seek our counsel in navigating these steps during an active bankruptcy case.

If notifying an owner of post-petition debt or a covenant violation fails to spark payment or cure, we may recommend the association consider filing a Motion for Relief from Stay if warranted by the amount of debt or severity of the violation. Through a Motion for Relief from Stay, the association asks the bankruptcy court to lift the automatic stay for the association because of the owner's failure to maintain post-petition assessments or correct post-petition covenant violations. If the court agrees with the association's position, then it will grant relief from stay to allow the association to proceed with a foreclosure of its lien for past due assessments or for a covenant enforcement action. The association will not be granted the right to garnish on a money judgement while a bankruptcy is pending; however, the association may be granted the right to pursue judicial foreclosure of its lien.

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Bankruptcy law is governed by a lengthy and complicated federal statute that can be difficult to navigate. Your NowackHoward attorneys are here to help and advise you when an owner in your community files bankruptcy. Please let us know if we can assist you in any way. [www.nowackhoward.com](http://www.nowackhoward.com)