

I N S I D E T H E M I N D S

Chapter 7 Consumer Bankruptcy Strategies

*Leading Lawyers on Navigating Today's Bankruptcy
Culture, Developing Chapter 7 Filing Strategies,
and Achieving Client Goals*

2011 EDITION



ASPATORE

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First Printing, 2011
10 9 8 7 6 5 4 3 2 1

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Strategies for Addressing Clients' Financial Difficulties

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Introduction

My legal career started in 1975 after I graduated from Brooklyn Law School. I represent individuals, businesses, and farms in all aspects of Chapters 7, 11, 12, and 13 bankruptcy, and since 1983, I have served as a trustee for the US Bankruptcy Court, Western District of New York.

I believe that the breadth of my knowledge in all levels of bankruptcy matters differentiates my skill set from those of a general practitioner. For example, if the owner of a corporation approaches me with financial issues, I am able to develop instant strategies; whereas, a practitioner specializing only in consumer bankruptcies may not understand the complexity of a corporate matter. In a typical example, the corporation owner may have sales tax issues or withholding taxes, which are of a personal responsibility, in addition to corporate guarantees; therefore, my goal is to handle the entire situation, personal and corporate—not just a portion.

Bankruptcy issues can be very complex, which is one of the reasons I find this area of law so interesting—there is always something new to learn and apply. In my thirty-six years of experience as a practitioner and trustee, I have seen almost every type of situation involving both individuals and businesses; yet I continue to see or hear of situations that are sometimes bizarre and unusual; for instance, some individuals and companies have had to dispose of bull semen, sell a marijuana field, or dispose of a radioactive rod from a nuclear power plant. As a result, I am forced to create a unique solution for the client. In addition, with legislation changing so frequently, one challenge is to determine what has recently changed and how it may be relevant to the client.

In this chapter, I will give an overview of many common reasons for filing a Chapter 7, identify current trends and client profiles, and suggest specific strategies you might use when consulting with a client who is having financial difficulties.

Reasons for Filing

Over the years, there have been many reasons people file Chapter 7. Although not exhaustive, they generally fall into several categories: loss of

income, divorce, medical expenses, managing already large debt load, bad business ventures, overuse of credit cards, and, more recently, the inability to retain a home. With each category, I have identified a number of underlying reasons.

Loss of Income

The first category, loss of income, is by either job loss or downsizing. When income drops, unless expenses also drop, there becomes an obvious problem. People have used their credit cards, retirement accounts, or funds from relatives to maintain their status. When this money runs out, in most cases it leads to default and potentially a Chapter 7 filing.

Divorce

Divorce, many times leaves a spouse with an ex who won't pay support or is chronically late with payments, and the spouse must find other ways to feed, clothe, or even protect the family. Many times credit cards are used for maintenance, ultimately leading to large credit card debt, default, and the filing of a Chapter 7.

Medical Expenses

Another reason for filing is often an unexpected illness or medical catastrophe that simply isn't covered by medical insurance, which then leads to the individual bearing the medical costs. One day in the hospital with major surgery can run \$20,000. Unless you have insurance, and many do not, you borrow, charge, or take legal action, such as filing a Chapter 7.

Already Large Debt Load

The fourth category concerns people who try to manage an amount already owed. Some people take a cash advance from one credit line, which takes the money from one card to pay another card, never reducing the debt. Others use retirement money or money from relatives. Again, once the money runs out, they look at Chapter 7 as an alternative.

Bad Business Ventures

Bad business ventures are becoming a more and more common for people to file a Chapter 7. The small mom-and-pop type business that operates on a shoestring has been a casualty. As the economy has turned downward, people have cut spending, so their discretionary dollars don't go to things such as dining out as much as before.

In one of my cases, a seventy-five-year-old owner of a twenty-five-year-old restaurant saw his sales go from \$800,000 to \$300,000 in just eighteen months. After he depleted his savings to try to keep the business open, he had no option but to file a personal Chapter 7 and close the business.

Overuse of Credit Cards

The sixth category is the overuse of credit cards to make up for the loss of a job, try to save a failing business, or pay needed expenses.

Many people have used credit cards with a charge-now-pay-later mentality, which will fail if the cards aren't paid off quickly. Interest and hidden charges have been serious added costs to credit card holders. Until recently, with the passage of the federal disclosure laws, if you failed to make a single payment on a charge card, even by mistake, your interest rate could have gone from 5 percent to 30 percent. Using, for example, \$50,000 of debt at 5 percent means interest of \$2,000 per year, or \$221 per month. Once it goes to 30 percent, then the interest is \$15,000, or \$1,210 per month. A normal household would have a severe financial crisis in this situation, possibly arriving at a Chapter 7.

Real Estate

The recent residential real estate crisis has also spurred many people to try Chapter 7. There have always been defaults and foreclosures; however, what has been seen during the last two years has been unprecedented. People who had adjustable-rate mortgages that would change rates after a short term have been seeing their property values drop at the time when they try to refinance, which results in the debt-to-value ratio being too high. In large areas of the country where these values have dropped, since lenders

haven't been willing to refinance, people walk away from their homes and file a Chapter 7. What is amazing to me as a practitioner is that lenders have refused in many cases to rewrite the loans to either reduce the interest rate or increase the term or both. This is not to say that all borrowers deserve to be helped, particularly those who were speculating and seeking to “flip” the house. As a result, areas such as California, Nevada, Michigan, Illinois, and Florida have seen huge numbers of foreclosures and Chapter 7 filings.

Newly Observed Filing Trends

I have seen some new trends and older ones that have become more pronounced and could change as economic trends change.

Elderly Population

It appears that more people over the age of sixty-five are filing Chapter 7. For a number of reasons, in addition to those already noted, there are increasing medical costs not being covered; inability to afford housing due to job loss; loss of value in retirement accounts; rise in cost of utilities, etc., while being on a fixed income; and the use of funds, credit cards, or financial resources used to help or support their children.

I believe this last development is now showing itself when elderly people are convinced, by either guilt or force, to use their assets or credit cards to help a child who is in a failing business or marriage or simply wants them to bail him or her out for a range of poor judgments and decisions. When the parents have used all their assets and are left with no emergency monetary cushion, they then are faced with debt they cannot repay. This has led many to filing Chapter 7.

Younger Filers

At the other end of the filing spectrum, younger people, under age thirty, are filing Chapter 7. They leave school with a large student loan debt and can't get work to pay it or pay for all their other necessities, such as rent, food, and gas, so they have resorted to credit cards for maintenance. After a while, these younger people decide to file for Chapter 7 to get rid of the credit card debt, even knowing they will have to pay back the student loans.

Higher-Income Filers

I believe, because of job loss, a higher standard of living with a higher debt load, and the inability to secure a job close to what they used to earn, more people with incomes in excess of \$75,000 are filing for Chapter 7. Many people who for many years were living the “American Dream” saw their incomes rise—along with their expenses. They wanted bigger houses, two cars, and vacations. They handled it all, until one or both lost a job or were downsized, with a resulting financial collapse and a Chapter 7 filing.

Small Businesses

As stated above, I see many more small businesses and business owners filing for Chapter 7. In addition to people spending only on necessities and putting off spending on items such as driveway repair, new windows, or a new refrigerator, many small businesses are not able to obtain credit from a lender. No longer is a handshake, a small amount of collateral, or even a business plan enough. It now appears you need significant assets to get any type of loan. Unfortunately, most small businesses do not qualify, can't get credit, and thus can't continue operation. As a result, the business and business owners are forced to file Chapter 7.

Debt Purchasers

Because of the failure of the credit industry to handle its own debt, many lenders have sold off large chunks of their credit card portfolios to debt purchasers. These debt purchasers buy the debt for pennies on the dollar and then go after the person for non-payment. I submit that if the original lenders worked with the customer, reduced the rates, and worked out payment plans, they might not have to write off debt or sell to debt purchasers.

Process Strategies

Initial Meeting

At the beginning of the process of a Chapter 7 filing is a successful initial conference with the potential client. Usually you don't know the person

and he or she doesn't know you. You need to establish trust and need to get to the reasons for his financial difficulties. I generally ask him to keep an open mind and say that most of what he has been told may not be accurate or applicable to his specific case. I ask him to hold his questions until after I can assess what's going on. I stress that since I usually don't have proper documentation, he will need to bring it with him to a follow-up meeting. Questions he asks may have different answers after I see what's going on. I use an analogy: "I'm the doctor, you're the patient. I need blood work and X-rays before I can give you a complete diagnosis." My clients generally understand. I also explain that they can usually choose from four options:

Do Nothing

Some people are what we call judgment-proof. Even if a judgment is entered against them, nothing will be lost. An example is the eighty-year-old woman who lives in an apartment, receives only her Social Security benefits, and has no car or other significant assets. Except for annoying calls, she actually doesn't need to file. Often, they need peace of mind, so they still request a filing.

Out-of-Court Workout

An out-of-court workout permits me to try to settle all of the client's debts at a significant reduction—say, 30 percent to 50 percent of the debt. The key, however, is that the funds to settle must come from a third party (such as a father) who will permit me to negotiate these settlements. I must receive the funds before I negotiate, since the creditors will generally not accept payment terms. Immediate cash payments will usually have the creditor discuss a settlement.

Chapter 7

This is a traditional straight bankruptcy. I explain that by filing, all actions are stayed, and potentially the clients' personal obligation to pay the debt is discharged (with some exceptions) if they file. What many don't know is that if they do nothing, and a judgment is entered, they could lose up to 10 percent of their gross income, and that judgments in New York are valid

for twenty years. The negative impact is significant if clients are trying to recover and re-establish credit.

Chapter 13

A Chapter 13 bankruptcy is a court-approved payment plan that permits payment of all or part of one's debt over a period of time under court supervision. Many people seek this protection, particularly if they have a debt, such as a tax, that cannot be discharged in Chapter 7. Chapter 13 affords the opportunity to pay off debt without creditor interference.

Follow-up after Initial Meeting

After discussing multiple options at the initial meeting, I give clients various checklists and worksheets to get the most accurate information. I explain that not completing the paperwork can have negative consequences, such as delay, cost, and possibly deciding on a wrong strategy. Most people understand that even though they are hiring me to do a job, their cooperation, focus, and following instructions can help save costs and time and can lead to acceptable solutions to their problems.

Probably the most important fact I can give a client is that with full disclosure, a plan can be formulated. I understand that many people do not have the best of records or even an understanding of why they are in the situations they are in. It is up to me to stress that their goal to get a fresh start is directly related to their taking control, focusing on the homework I ask for, and starting to make changes in the way they live and do their buying. For example, many people are not sophisticated and don't understand how they can be charged various interest rates on their charge cards and how it increases the cost of the purchase if the charge is not paid off immediately.

I use a questionnaire and checklist with my clients, as well as copies of the actual forms that are filed with the court. I go through each item and explain what I need. I require that clients write down each creditor alphabetically with name and address, account number, and amount owed. This helps them focus. I make them get a credit report to see whether they missed anything. I require copies or originals of all documents, such as last

bill, tax return, deeds, and car loan documents. I show them that everything is important. I then explain that it may seem overwhelming, but they should do one item at a time. I also ask that they write down all their questions so we can go over them at our next meeting.

Documentation

The documentation that is requested and reviewed will tell you many things the client may have forgotten or honestly doesn't know or understand.

Tax Return

Get at least three years of returns. Examine them carefully. Has there been a change that is shown, such as an income drop, or show business deductions, or dividends from stock owned that the client needs to explain? You don't want to file papers, go to the meeting of creditors, and have the trustee ask about these matters when you're not prepared. This can have a serious impact on the administration of the case.

Pay Advices

Get pay advices, or stubs, for a year and look at them. Did your client get a bonus? Is there money being taken out of his or her pay because of a wage execution from a judgment?

Ownership Documentation

Deeds, title certificates, car leases, and copies of retirement account statements are examples of items you must review to confirm who owns the property, what liens there may be, and whether the property can be exempt. These papers will also tell you—for example, with a deed—who the previous owner was and when it was transferred. A recent case I had showed a transfer between relatives that could have resulted in the trustee possibly filing a fraudulent transfer action. Because I knew about it, I was able to analyze this to see if this would be a problem.

Bills

Get a copy of the last bill for each debt. You need to confirm the correct account number, addresses, and amounts. If there are large balances, you need to find out what the money was used for and when. These answers may help later, should there be an objection to discharge filed by a creditor or the offices of the US trustee.

Miscellaneous Questions

I find that asking questions that are not expected might produce answers that can be important in determining how to proceed. One question I ask is, “Have your parents put you on their deed?” I find that without the knowledge of their children, parents have deeded property to them to protect it for a variety of reasons. If your client is one of these children and files a case, and your client’s name is on the title, the interest your client has is now owned and controlled by the trustee. This can have serious unintentional consequences.

Follow-up Meetings and Questions by the Client

At the follow-up meeting, we go over the information the client has brought with her, hoping it is complete enough for us to discuss solutions. I do not expect the paperwork to be perfect, but I do expect enough that we don’t waste time. Most people realize this work helps them find ways to get out of their financial problems, and they cooperatively will do what is asked of them.

The client usually has a variety of questions. Should I continue to pay my bills? Will I ever get credit again? Do creditors have a right to sue me after I file a Chapter 7? If you don’t have the information, you can’t advise them properly. Depending on the individual circumstances could mean a different answer for each client. No client’s situation is the same and has to be reviewed on a case-by-case basis. When you, as an attorney, become too complacent, things will fall through the cracks, and problems will arise.

Implementation of BAPCPA and Recent Case Law Developments

BAPCPA

Congress approved the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) to ferret out abuse that was perceived in the system. This act created a number of tests and standards that new bankruptcy filers are required to meet and follow.

When the act was instituted, there was a perception that people would no longer be able to file a bankruptcy proceeding, so there were large numbers of filings before the effective date. If one excludes the 2005 year of filing, the number of filers nationally now appears to be reaching the same levels as before. BAPCPA may have restrained or caught some filers, but I submit that Chapter 7 levels have continued to be significant, since it never dealt with the reasons for the need to file a bankruptcy. Also, the recession took hold in 2007 and 2008, with those people subject to loss of home, loss of job, large medical expenses, or failed businesses—many of the same reasons for filing before BAPCPA. .

Another reality is that treatment of filers has been different, depending on the geographical location. In my district, the Western District of New York, issues of abuse have been dealt with for years. With or without BAPCPA in effect, an active court would always seek to hold abusive filers accountable. As a lawyer, one needs to be focused on what the courts and the Office of the US Trustee are looking for. If you have a case that might fall into one of the categories to be reviewed, you need to be prepared, and your client needs to be advised and warned of that possibility.

One of the most controversial tests used by BAPCPA is the means test. This formula is used to analyze income and expenses to determine whether a filer is presumed to be abusive. If so, there will be many questions to be answered, and the client might ultimately not get his Chapter 7 discharge. An abusive case under the means test, as well as an independent review of income and expenses, could result in a motion being brought by the Office of the US Trustee to deny the case from proceeding and deny a discharge of debts. As an attorney, you need to be diligent and complete and do a proper review before filing a case to see whether these possibilities exist.

Recent Case Law Developments

Exemptions

All states have various exemptions of property, so when a person files a Chapter 7, not everything will be lost. Some states are conservative, some liberal, and it is crucial that these exemptions be fully understood. Not knowing how your client's property interests are affected could have a disastrous result after filing.

In New York, a new set of exemptions became effective January 21, 2010. The result was a conservative law becoming liberal. As an example of how it would have affected a person who filed one day before the effective date and one who filed after the effective date, let's look at tax refunds. Assume there is a couple, with no real estate, who files before the new law. Each person could have exempted up to \$2,500, or a total of \$5,000 in cash, bank balances, and tax refunds before the effective date. If the refunds were \$10,000, one-half would be exempt, and one-half would have to be turned over to the trustee. Under the new law, the amounts were doubled. Because of the change, in my example, the couple now could keep the entire \$10,000, and nothing is paid to the trustee.

Recent Cases

- *Schwab v. Reilly*, 130 U.S. 2652 (2010). The court determined that debtor attorneys must take the full amount of the exemption because if they do not, the trustee could take the position that the debtor is not entitled to the appreciation in value. This case involved an appreciation of value of an asset, and the debtor claimed a certain amount. When it was sold, it was actually a much greater amount, but the debtor received only the amount that was claimed, while the trustee received the difference.
- *United Student Aid Funds v. Espinosa*, 130 S. Ct. 1367 (2010). The Supreme Court held that the provisions of a confirmed Chapter 13 plan, even if confirmation was in error, are binding on creditors who were properly noticed and failed to object or appeal the confirmation in a timely manner. For a student loan to be discharged, the court must first find an undue hardship, as set forth

under the Bankruptcy Code. In this case, however, a provision discharging student loans without a finding of undue hardship was confirmed by the court on notice to the creditor. Years after completing his Chapter 13 plan and getting his discharge, the student loan company tried to collect the remaining balance. The Supreme Court held that the plan was confirmed in error, but since the creditor had proper notice at the time, it was too late now, as the confirmation was a binding, final order, and the time to object or appeal had passed long ago.

- *Milavetz, Gallop & Milavetz PA v. United States*, 130 S. Ct. 1324 (2010). The Supreme Court held that a bankruptcy attorney is a “debt relief agency,” as defined in the Bankruptcy Code. Among other things, the bankruptcy attorney must identify himself a debt relief agency in any advertisement and may not advise clients to incur new debts in contemplation of bankruptcy. The Court was clear, however, that a bankruptcy attorney might have valid reasons to advise a client to incur new debt other than in contemplation of filing bankruptcy (vehicle replacement going into a five-year plan, roof caving in, etc.).

Overall Strategies and Cautions

As already stated, before effective strategies can be determined, you must have proper documentation, be up to speed on new cases, and know the positions of the court in which you are practicing.

Lawyers should always be candid and honest with the trustee, the Office of the US Trustee, and the court. If the impression is that there is manipulation or even deceit, there will be a closer review of what you have filed. If you have made a mistake or misjudged a position of the trustee, it can be embarrassing and costly.

You should have a plan to deal with any non-exempt asset before you file your case. You should always provide the documentation to the trustee before his hearing, and you should be punctual to the hearing. One of the most irritating things to a trustee is the cavalier attitude some attorneys have in failing to provide documents and arriving late. You could have a trustee who simply won't take the case and would adjourn it to another time. Try explaining this to a client who has taken time off from work and is trying to get a fresh start.

Sometimes it is difficult to discuss with the client what to do with a non-exempt asset, such as the excess equity in a home, a car, or tools, for example. Probably the worst thing that can be done is trying to transfer or dispose of the asset before filing. As an example, the cabin in Canada that the client doesn't want to lose is transferred to a relative within the year of filing. Because of fraudulent conveyance statutes, the asset might not be protected, and the trustee could seek to set the transfer aside and then sell the asset to realize money for creditors. Maybe a proper way to have handled this is to promptly appraise the property, discount it for the difficulty to liquidate, and have waiting for the trustee an offer of a cash settlement. One client I represented had a timeshare in Florida, had purchased it for \$14,000, and had no debt against it, but because of the current real estate market, the trustee was glad to get \$1,500 to let the client keep it. The client took some money from his IRA to pay for it, and it was a win-win.

Another concern is the failure to investigate the history of an asset. For example, a client comes in to see you and you don't check to see whether he has owned real estate in the last six years. The case gets filed, and it is discovered that your client was divorced four years ago and transferred his ownership to his ex-wife and now, under New York state law and many other state laws, the trustee can look back six years to see whether there is a fraudulent conveyance. It all may have been innocent, but if there were debts owed back then that are being discharged and there is equity in the house, the ex-wife may be faced with the trustee seeking to sell the real estate.

Another real estate caution is the situation where parents have deeded their home to their children, but reserved a life estate. Your client, being one of the children, now files a Chapter 7. The trustee will now own that child's percent interest in the home. This can be costly and upsetting not only to the parents but also to the brothers and sisters who might have to come up with money to purchase back the percent owned by your client.

Conclusion

I believe that while the economic recovery seems to be kicking in on a slow scale, bankruptcies will continue, but will also be dropping from the numbers

of the last few years in most geographical areas. There will be exceptions, such as in the area of Western New York, where there has been a steady decline since the higher levels of 2002 through 2004 (2005 being an exception due to the law change). I can see that once the real estate debacle has passed in states like Nevada, California, Florida, Ohio, and Illinois, and since lenders are being tighter on giving credit, we should see significant drops in Chapter 7 filings. Unfortunately, until medical costs drop, unemployment levels drop, and credit for small businesses eases, there will still be filings.

Strategies in preparation will affect your decision on the course of action your client will take. Remember, it will depend on the documentation provided to you and a complete knowledge of your client's situation, as well as current cases, local procedures, and positions of the court in which you practice.

Key Takeaways

- Help clients get past their emotional issues when filing for bankruptcy. Clients often feel guilty and embarrassed, but bankruptcy attorneys should help them realize that these feelings are natural and that if the situation is right, bankruptcy can be an opportunity for a fresh start and a way for clients to learn from their past mistakes to create a better future.
- Refrain from pre-judging clients when they come into your office. Each client and story is different, and to create a successful bankruptcy strategy, it is important to approach the situation with a clear mind.
- Challenge your clients and get the full stories behind their problems. The first information you receive may not always be the correct information.
- Complete your homework and make sure the clients complete their homework. To create a complete and successful bankruptcy strategy, it is essential that you understand the unique situation presented to you by your clients.
- Preparation and complete documentation is the foundation of good decision-making.
- Stay on top of the changes in the law, as well as procedures and positions of the court in which you practice. If you do not, the consequences can be severe.

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In addition to general practice of law, Mr. Lustig focuses on representation of individuals, businesses, and farms in all aspects of Chapter 7, 11, 12, and 13 bankruptcy proceedings. He also handles workouts for financially distressed businesses and individuals, residential and commercial real estate for consumers and lenders, and legal issues affecting small businesses.

Mr. Lustig is active in local, state, and national attorney organizations: local and national bar associations, National Association of Bankruptcy Trustees, Commercial Law League of America, American Bankruptcy Institute, and others. He also has an AV rating by Martindale Hubbell. From 2005 to the present, he has been named to Super Lawyers, Upstate New York.

Mr. Lustig earned a BS from Syracuse University in 1971, and his JD from Brooklyn Law School in 1974.



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