

## **Useful tools that Rhode Island General Practitioners Should Know about Bankruptcy**

Consumer debtors facing financial struggles may come to you seeking advice as to how they may obtain protection from creditors by filing a petition in the United States Bankruptcy Court. When a debtor in financial stress comes into an attorney's office , considering bankruptcy, he and his attorney will have to make a determination as to which chapter of the code is appropriate and most beneficial for the debtor's circumstances, or even whether the debtor should file for bankruptcy at all. This article discusses the relief available to debtors under chapter 7 and chapter 13 of the Bankruptcy code, which are the generally practical provisions that should be considered by consumer debtors and their attorneys.

Chapter 7 of the Bankruptcy code allows debtors to discharge general unsecured debt in bankruptcy court. In a chapter 7, which is a liquidation of the debtor's estate, all non-exempt assets are sold by the trustee and used to pay the creditors estate. The debtor is provided a discharge of the debt, regardless of the amount, if any is recovered by the chapter 7 trustees. This discharge is essentially an injunction that prevents the creditors from pursuing the debtor for the debt.

### **11 USC 727**

There are some debts, including recent taxes, most student loans and child and spousal support, generally are not dischargeable and the debtor will remain responsible for these debts even after obtaining a discharge under 11 USC section 727. A complete listing of the exceptions to discharge to a chapter 7 is set for at 11 USC 523. For some of these exceptions, the burden is on the creditor to file a claim alleging non dischargeability

of the debt in an adversary proceeding. If the creditor fails to timely bring such an adversary proceeding, it will lose its right to claim that the debt should not be subject to the discharge.

Chapter 13 Bankruptcy allows distressed debtors with regular income to reorganize their debt. A Chapter 13 bankruptcy petition and plan can provide the debtor with the opportunity to catch up on any arrearage on mortgage payments and pay a portion of their unsecured debt based upon what they can afford.<sup>1</sup> The specific contents of what is required under a Chapter 13 plan are set forth in 11 USC 1322. Typically, the plan requires the debtor to pay his disposable income to the trustee over a three to five year period. Also, the amount paid into the plan must cure any arrears on the secured debts, including home mortgages, and must pay priority claims including taxes in full. The general unsecured claims receive a percentage of their claims based upon the debtor's ability to pay. These general unsecured creditors must receive in a chapter 13 at least the same amount of recovery that they would have received in a chapter 7. A successful completion of a chapter 13 plan has the effect of providing a debtor with a discharge of some of the debts that are otherwise not dischargeable under chapter 7. **11 USC 1328.**

Any asset that is not exempt will be liquidated and sold by the trustee for distribution to creditors, or the debtor may protect the asset by way of a chapter 13

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<sup>1</sup> As part of the 2005 Bankruptcy and Abuse Prevention Act of 2005, consume debtors must complete a means test to determine whether he or she should file for chapter 7 or 13 bankruptcy protection. The means test considers the debtor's income, family size and the expenses in the area where the debtor resides that are allowed by IRS regulations to determine whether the debtor is eligible to file under chapter 7 or whether such a filing is considered abuse. The purpose of the legislation is to get debtors who can afford to pay all or part of their debt back to file chapter 13 petitions.

petition that provides for payments into a plan an amount that is equal to or greater than the value of the asset that is not exempt

The bankruptcy abuse and prevention act of 2005 was designed to encourage those debtors that can afford to pay some or all of their debt back, to file a chapter 13 petition. The act developed a means test based upon a debtor's income and the expenses in the area in which he or she resides to determine whether their income is over a level where it would be considered abuse if the debtor filed chapter 7.

### *III. Property Exemptions:*

Many debtors worry that they will lose their property if they file for bankruptcy protection. It is true that the debtor must in his Bankruptcy petition disclose all of his assets under 11 USC section 541.<sup>2</sup> However, most assets of typical debtors are entitled to protection and are not subject to creditors claims under state and federal law. 11 USC 522.

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<sup>2</sup>11 U.S.C. § 541(a). The Supreme Court has determined that the scope of section 541(a) is broad. See United States v. Whiting Pools, Inc., 462 U.S. 198, 204-05 & n. 9, 103 S.Ct. 2309, 76 L.Ed.2d 515 (1983) (based upon the statutory language and legislative history, "Congress intended a broad range of property to be included in the estate"); Tringali v. Hathaway Machinery Co., Inc., 796 F.2d 553, 560 (1st Cir.1986) (same). In ascertaining the existence and scope of a debtor's legal and equitable interest in property, the Court must look to state law. Riley v. Tougas (In re Tougas), 338 B.R. 164, 173 (Bankr.D.Mass.2006).

Section 541(c)(2) of the Bankruptcy Code carves out an exception to section 541(a). It provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." 11 U.S.C. § 541(c)(2). As the court stated in In re Spenlinhauer, 182 B.R. 361 (Bankr.D.Me. 1995), aff'd 195 B.R. 543 (D.Me.1996), aff'd, 101 F.3d 106 (1st Cir.1996), "[s]ection 541(c)(2) and its historical antecedents have operated to save unto the debtor his or her interest in a valid `spendthrift trust.'" 182 B.R. at 363 (citations omitted).

In his petition, the debtor must elect to claim either state or federal exemptions under the bankruptcy code. The specific federal exemptions are set forth in 11 USC 522. The federal homestead exemption is currently \$20,200.00 per debtor. In addition federal law provides for a wild card exemption of up to \$11,200.00 per debtor of any unclaimed portion of the debtor's federal homestead exemption, the federal exemptions also protect pension and retirement accounts. For a complete listing of the federal exemptions see 11 USC 522.

RIGL section 9-26-4 and 9-26-4.1 sets forth property that a debtor may claim as exempt if he or she opts to elect the Rhode Island exemptions. The Rhode Island exemptions include: wearing apparel, working tools valued at up to \$1,200.00, household furniture, money contained in a qualified individual retirement account, a motor vehicle valued up to \$10,000.00 and jewelry valued up to \$1,000.00. In July 2008 Rhode Island added a wildcard exemption, which allows the debtor to protect any assets that are not otherwise covered an exemption up to \$5,000.00. RIGL 9-26-4 (16). In many cases, the most significant exemption under Rhode Island law is the homestead exemption which allows the debtor to protect up \$300,000.00 in equity in their home. In order to qualify for the homestead exemption the property must be either occupied by the debtor or the debtor must intend to occupy the property as the debtor's principal residence. In re Franklino, 329 B.R. 363 (Bank D. RI 2005) in some cases recently acquired property the homestead exemption can be reduced. See, 11 USC 522 (o)(p) and (q).

To the extent that creditors have obtained judgment liens against creditors against assets of the debtor, the debtor may obtain an order from the bankruptcy court

avoiding judgment liens on their property to the extent that the exemption is impaired by judgment lien. 11 USC section 522 (f) (1).

### **Spendthrift trusts.**

Property contained in a spendthrift trust is not considered an asset of the debtor's estate, provided that it is not a self settled trust, and the debtor does not have control over the disposition of the trust. **RIGL Section 18-9.1-1**; .Aylward v. Landry (In re Landry), 226 B.R. 507 (Bankr.D.Mass.1998), and In re Cowles, 143 B.R. 5 (Bankr.D.Mass.1992) (concluding that in order for trust assets to be included in the bankruptcy estate there must be a "finding that the trust was self-Settled and that certain powers were reserved by the settler/beneficiary or settler/trustee); 11 USC 541( c ) (2) (providing that a "restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable no bankruptcy law is enforceable in a case under this title.")

### III.Divorce:

Attorneys who practice divorce should be cognizant of the homestead exemption when considering how the marital estate is divided. When dividing up the marital estate, it may be to the parties' advantage for one or both parties to claim bankruptcy to clear up the unsecured debt. The divorce attorney must be careful to consider the homestead exemption and its application, particularly if he represents a debtor that no longer resides in the home, or is considering vacating the marital home. A divorce client who no longer resides in the home may not be able to protect his or her interest in the home by using the homestead law exemption, inasmuch as he or she no longer resides in the home or intends to reside in the home.

### IV. Taxes:

The debtor may be able to discharge bankruptcy, taxes owed to the IRS and to the state provided that the IRS does not have a lien on the debtor's real estate, the debtor files his/her tax returns in a timely fashion, the period for filing the taxes is more than three years old or filed late but filed at least three years ago. Such old unpaid taxes are no longer priority claims and can be discharged. The exception is when the debtor willfully evades taxes. However, even in these cases, the debtor may be able to obtain a discharge in a chapter 13 petition as long as the plan makes some provision for the payment of these taxes.

#### V. Chapter 13.

In addition to providing the debtor with a method to resolve or reduce outstanding debt through a payment plan, a successful chapter 13 plan may provide a mechanism to allow debtors to cure defaults on their mortgage payments so that their home is saved from a foreclosure, the following are some examples as to how a debtor could be assisted by the filing of chapter 13 bankruptcy petition.

##### A. The Upside Down House with a Second Mortgage:

In today's market of declining house prices, some debtors owe more on their home loans than their home is actually worth. In some of these cases, the debtor may have a second mortgage that is wholly unsecured, which under the bankruptcy code means that the amount that is owed on the first mortgage is equal to or greater than the value of the home. In these cases, the debtor may be eligible to step down the second mortgage as part of their chapter 13 petition. The stripped down mortgage is treated a general unsecured claim, and the lien is avoided. 11 USC 1322 (a); 11 USC 506 (a); In re McDonald, 205 F3rd 606;

In re Griffey, No. Co 05 (10<sup>th</sup> Cir. 2005). Debtors with unfavorable interest rates on their first mortgages on their homes should, however, make efforts to modify their loan with the lender prior to filing bankruptcy, because under current law debtors may not compel a modification of the terms of their first mortgage on their home in bankruptcy courts. 11 USC 1322 (b)(2). This may factor into the debtor's decision as to whether they will seek to keep the home at all.

#### B. The Upside Down Car:

Some debtors have large car payments and the value of their car is much less than the price of the car and may also be paying a high interest rate. Under the cram down provisions of the bankruptcy code, the secured portion of the loan is reduced to the value of the car at the time of the filing of the petition. 11 USC 06.

Additionally, the loan can be modified so that the debtor can obtain a more orable interest rate on the remaining secured portion of the claim. 11 USC section 1322 (b) (2). However, a car loan that was obtained in the 910 days before the filing of the petition cannot be crammed down to its actual value, because the entire hole loan is treated a secured claim. 11 USC 1325 (9 ) providing that "For purposes of Paragraph (5), section 506 shall not apply to a claim described in that paragraph if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle (as defined in section 30102 of title 49) acquired for the personal use of the debtor, or if collateral for that debt consists of any other thing of value, if the debt was incurred during the 1-year period preceding that filing.

## Conclusion

The purpose of the Bankruptcy Code is to provide a fresh start to honest but unfortunate debtors. In these difficult economic times, general practitioners should be familiar with Bankruptcy basics so that they may properly advise their clients who may be distressed debtors, or who may be creditors seeking to pursue a claim against a distressed debtor. A creditor who is unrealistic in their expectations as to whether a debt is collectable may learn the hard way that bears make money, bulls make money, pigs do not make money.

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