TIPS FOR CONSUMER DEBTOR ATTORNEYS

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This outline attempts to identify issues that may be lurking in Chapter 7 consumer bankruptcy cases, and identify steps that counsel may take to make these issues more manageable as the case progresses.

1. Post-petition Litigation.

In some cases, there will be a strong indication going into the case that there will be post-petition litigation against the debtor. This could include objections to discharge or dischargeability, litigation concerning exemptions, motions for relief from stay, and motions to convert under section 707. For instance, the debtor may be subject to a state court lawsuit alleging fraud prior to filing, which is a strong indication that there may be an objection to discharge or dischargeability.

First of all, counsel should carefully limit the scope of his or her initial engagement to filing of the bankruptcy case, attendance at the meeting of creditors, and routine interactions with the trustee. Unless financial arrangements have been made in advance, counsel would be wise to exclude contested matters and adversary proceedings from the scope of the initial engagement. Limited representation, also known as "unbundling", is authorized by the Rule of Professional Conduct 1.2(c), subject to disclosure requirements and overall reasonableness. See Zach Mosner, Unbundling and Ghostwriting: Who Ya Gonna Call?, ABI Journal September 2016 at page 14.

Assuming counsel is willing to take on the defense of a dischargeability case or motion to convert, the problem, then, is: how does counsel get paid for defending these actions? Under Lamie, 540 U.S. 546 (2004), property of the bankruptcy estate may not be used to pay debtor's attorney fees. Under Washington Rule of Professional Conduct 1.15A, money held in an attorney's trust account to cover future fees remains property of the client. Therefore, an advance fee deposit in your trust account on the petition date becomes property of the bankruptcy estate. Notwithstanding counsel's claim to a possessory lien, such funds cannot be used to pay the debtor's attorney fees. That leaves four possible sources of payment for post-petition litigation: debtor's post-petition earnings; exempt property; post-petition gifts or loans from third parties; and a pre-paid, fully earned, flat fee.

If your client has non-exempt property that can be quickly liquidated, you may decide that a pre-paid flat fee is the best way to provide for the debtor's defense. Carefully review the requirements of RPC 1.5(f). Make your best estimate of what it will cost to get through the litigation, because you are agreeing to do the litigation for the flat fee, and not a penny more or less. Have a written fee agreement covering the flat fee. Disclose in that agreement that, if the client is entitled to a refund of all or part of the flat fee (for instance, because the creditor unexpectedly did not bring an objection to dischargeability), any refund will be payable to the bankruptcy trustee, and not returned to the debtor. Finally, be sure you disclose the flat fee arrangement in the disclosure of compensation filed as part of the bankruptcy schedules.

2. Homestead Exemption

2.1 Claiming the exemption.

Typically, the debtor estimates the fair market value of their residence, perhaps based on Zillow or a CMA, and deducts the amount of the mortgage(s) and taxes to reach the exempt amount of the homestead. When property is appreciating, that may lead to the debtor leaving exemption money on the table. A better approach may be to claim the exemption in the full statutory amount, even if equity to support the exemption does not exist on the petition date.

Under the "snapshot rule", exemptions are determined as of the filing of the petition. 11 U.S.C. § 522(b)(3)(A). See White v. Stump, 266 U.S. 310, 313 (1924); Owen v. Owen, 500 U.S. 305, 314 n.6 (1991); In re Zibman, 268 F.3d 298, 304 (5th Cir. 2001). Can this rule be interpreted to mean that a debtor may not amend her exemptions to capture post-petition appreciation in the asset? Exemptions are to be liberally construed in favor of the debtor. Amendments to schedules, and in particular to Schedule C, are to be freely allowed. However, at least one decision in this District has disallowed such an amendment[1].

Can the debtor exempt "100% of fair market value up to the exemption limit", as the Supreme Court suggested in dicta in Schwab v Reilly, 130 S.Ct. 2652 (2010)? New Official Form 106C specifically includes this language as an option to check. But some courts have held this to be impermissible under the federal exemption statute, and required debtors to assign a dollar value to their exemptions. See Massey v. Pappalardo (In re Massey), 465 B.R. 720 (BAP 1st Cir. 2012) (Section 522 exempts the "debtor's interest" is a piece of property, not the property itself). By contrast, under

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[1] One situation in which amendment of the homestead exemption might properly be disallowed is where the debtor stands by while the trustee puts in significant time, effort and expense to liquidate a property, and the debtor seeks to amend only after the trustee has negotiated a successful sale. See In re Aubry, 558 B.R. 333, 2016 Bankr. LEXIS 3453 (Bankr. C.D. Cal. 2016) (Belated attempt to exempt personal injury proceeds denied, applying California law of equitable estoppel. Under Law v Siegel, 134 S. Ct. 1188 (2014), the estoppel must arise under the state law creating the exemption; no federal law authorizes denial of exemption for debtor misconduct.)

Washington law, " The homestead consists of real or personal property that the owner uses as a residence." R.C.W. 6.13.010. See Marc S Stern and Janine Lee, Proper Valuation of Property and Exemptions in Consumer Cases, ABI Journal July 2014, page 22.

Is it permissible for a debtor claim the full dollar amount of the homestead exemption, even if the debtor's equity in the property is less than the exemption limit? New Form 106C calls for the debtor to list the "amount of the exemption you claim", not the "value of claimed exemption" as was called for by former Form 6C. See In re Christensen, 2016 Bankr. LEXIS 4312 (Bankr. UT 2016) (trustee cannot sell debtor's residence without paying debtor full amount of homestead exemption). Note that Washington law prohibits the forced sale of homestead property unless the sales price exceeds the exemption amount. R.C.W. 6.13.160.

Alternatively, would it be permissible for the debtor to schedule the value of his homestead property at a level that uses the maximum exemption amount, even if there is doubt that the property could actually sell for that amount as of the petition date? Is overstating the value of property grounds for denial of discharge under 727(a)(4)(A)? How is the estate harmed by over-valuation? And if the property appreciates to something close to the scheduled value before the case closes, was it then really an over-valuation?

Should a debtor seeking to exempt appreciating property track its value on Zillow.com or a similar reference source, and periodically amend his exemption to reflect the appreciation?

Finally, note that property coming into the estate after the petition date, for instance by inheritance, can still be exempted. In re Waltz, 546 B.R. 846 (Bankr. MN 2016). See also In re Diaz 547 B.R. 329 (9th Cir BAP 2016).

2.2 Forcing Abandonment

If the trustee believes there is equity in homestead property beyond the exemption amount, he or she will try to sell the property. What can the debtor do to prevent the loss of their home?

In In re Gebhart, 621 F.3d 1206 (9th Cir. 2010), the Ninth Circuit specifically mentioned a motion for abandonment as an appropriate tactic for a debtor seeking to preserve ownership of an exempt but appreciating asset. How can the debtor best position their case to force abandonment? The first thing is to not make any post-petition mortgage payments. Post-petition interest on the mortgage will eat away at whatever equity exists in the property. Sooner or later, the mortgage creditor will move for relief from stay. When the mortgage creditor files for relief from stay, the debtor should file a motion for abandonment, preferably to be heard at the same time. In the meantime, mortgage payments should be set aside, perhaps in counsel's trust account, so they are available to cure the mortgage arrears when the property is formally abandoned.

2.3 Reinvestment of Proceeds
Under the "snapshot rule" exemptions are determined as of the petition date. Post-petition events do not normally affect the right to an exemption. However, several state exemption statutes limit the duration of the exemption of homestead proceeds, requiring them to be reinvested in a new homestead within a fixed time to retain their exempt character. The state exemption statutes also differ in how they characterize the nature of the exemption. The Washington exemption statute, like the Texas statute, exempts the real property itself, not just the proceeds. The California, Arizona and federal statutes, by contrast, exempt the proceeds of the real property. Thus, in Texas and Washington, it should make a difference whether the debtor held the real property or its proceeds on the petition date.

The Washington reinvestment provision is in RCW 6.13.070, which provides "The proceeds of the voluntary sale of the homestead in good faith for the purpose of acquiring a new homestead, ... , up to [$125,000], shall likewise be exempt for one year from receipt, and also such new homestead acquired with such proceeds." By contrast, RCW 6.13.180 has no time limit "The money paid to the owner [from an execution sale of the homestead property] is entitled to the same protection against legal process ... which the law gives to the homestead." Thus, a debtor who sold their home and was holding proceeds on the petition date must reinvest them or lose the exemption. But is a sale by a bankruptcy trustee under Bankruptcy Code §363 a voluntary sale to which RCW 6.13.070 applies, or a forced sale to which RCW 6.13.180 applies?

The following cases are instructive: In re Golden, 789 F.2d 698 (9th Cir. Cal. 1986); Wolfe v. Jacobson (In re Jacobson), 676 F.3d 1193 (9th Cir. 2012); In re Smith, 515 B.R. 755 (Bankr. D. Ariz. 2014); In re D'Avila, 498 B.R. 150 (Bankr. W.D. Tex. 2013).

If the debtor does have to reinvest the proceeds within 1 year, there are practical difficulties. $125,000 will not buy much of a house in the Seattle area; still less if the exempt proceeds are less than the statutory maximum. The debtor will not be able to get a mortgage loan while the case is open (and the case will be open in this situation, because if it has been closed, the proceeds will have been abandoned by operation of Bankruptcy Code §554(c)). One possible solution is for the debtor to use the exempt proceeds to pay rent post-petition. See Sticka v. Casserino (In re Casserino), 379 F.3d 1069 (9th Cir. 2004) (Oregon law); In re Bencomo, 2016 Bankr. LEXIS 2901 (BAP 9th Cir. 2016) (California law). The Washington homestead exemption does not require the debtor to hold fee title to the homestead property. The debtor need only have such ownership as gives him the right to reside on the property. See Downey v. Wilber, 117 Wash. 660, 202 P. 256 (1921). Query: If the exempt proceeds are more than enough to pay one year's rent, may the debtor pre-pay rent within the one year reinvestment period?

3. Ongoing Liabilities

It is important to advise the debtor about certain ongoing liabilities that will not be suspended or discharged in the bankruptcy case.

3.1 Condo and HOA Dues

Condominium and homeowner association dues accruing post-petition are not dischargeable, and continue to be a legal obligation of the debtor so long as they have a legal, equitable or possessory ownership interest in the property. Bankruptcy Code §523(a)(16). After the collapse of the housing market in 2008-2009, banks were reluctant to foreclose on condominium properties, even when the debtors were not making mortgage payments, because third-party buyers were scarce and after foreclosure the bank would be liable for monthly condo dues. Debtors should be advised of this before they decide to vacate or abandon a condominium property. Even if the debtor does not intend to keep the condo long term, it may be advisable to rent it out for at least enough to pay the condo dues, until the mortgage lender decides to foreclose.

3.2 Utilities and Insurance

Typically Chapter 7 trustees do not carry casualty or liability insurance bankruptcy estate property, and the mortgage lender's insurance protects only the lender's interest. The debtor remains the record owner of the property, and could be subject to suit if someone is injured on the property while the trustee is administering it. Local municipalities will also continue to bill the debtor for utilities until utility service is switched to a new owner. Yet the debtor may have abandoned the property and moved out of state. The debtor should be counseled to maintain at least liability insurance on the property until it is sold or foreclosed.

4. Discharge of Tax

The ability to discharge income tax liabilities is a critical part of the bankruptcy fresh start. Maximizing the amount of tax that is discharged requires careful timing. Debtor's counsel should analyze the debtor's tax situation to determine what taxes may be dischargeable, and when the petition may be filed to maximize the discharge of taxes. This involves calculating when the following periods have run:

3 years from the date the return was last due, including extensions;
2 years from the date the return was actually filed[2]; and

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[2] The Ninth Circuit Appellate Panel has refused to follow the *McCoy* rule, that a tax return filed one day late renders the tax forever non-dischargeable. United States v. Martin (In re Martin), 542 B.R. 479 (B.A.P. 9th Cir. 2015). Had it adopted the McCoy rule, the tax discharge analysis would be much simpler: if the return was late, no

240 days from the date the tax was assessed (with adjustment for periods during which a offer inc compromise was pending or the stay of a prior bankruptcy was in effect.

The only reliable way to calculate these time periods is to get the debtor's tax transcript from the IRS. Relying on the debtor to determine these dates is generally not sufficient.

5. Statement of Intent

Some courts have held that a debtor's statement of intent under Bankruptcy Code §521 can be the basis of judicial estoppel: if the debtor indicates an intention to surrender the property, the debtor may not later contest the foreclosure of the property. Failla v. Citibank, N.A. (In re Failla), 838 F.3d 1170 (11th Cir. Fla. 2016). Other courts have held that the statement of intention does not create an estoppel. In re Ryan, 560 B.R. 339 (Bankr. D. Haw. 2016). See Gershoni and Moon, Lien on Me: Surrender, Reaffirmation and Right to Defend a Post-Discharge Foreclosure Action, ABI Journal December 2015 at 30. Counsel should advise the debtor about the potential consequences of the choices they make on their statement of intention. It is not common practice in this district to reaffirm a home mortgage. But simply maintaining payments is not an option expressly provided by section 521. If the debtor chooses "surrender", would they be estopped to contest a post-bankruptcy foreclosure that was based solely on an ipso facto clause?

6. College Tuition

Does the debtor have college-age children? If so, there are a number of potential issues counsel should address. The most prominent in the news is the effort of trustees in some jurisdictions to claw back tuition payments as fraudulent transfers. The theory is that the parent derives no benefit and discharges no legal duty in paying tuition for an adult child. One commentator has pointed out that in most cases the college is appropriately viewed as a mediate or immediate transferee, entitled to a good faith defense under Bankruptcy Code §550(b). Wilton & McGee, Robbing Peter to Pay for College: A Good-Faith Defense in Tuition Clawback Fraudulent Transfers, ABI Journal November 2016 at page 32. However, that simply shifts the target of the fraudulent transfer action to the student, who could see her summer earnings or her financial aid stipend garnished by her parents' bankruptcy trustee. A better solution is to recognize the economic reality that expenditures for dependent adult children do in fact provide a benefit to the parents. This can be done through case law or by legislation. The WSBA Debtor-Creditor Section has proposed such legislation to Olympia is it considers amendments to the UFTA.

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discharge.

Another pitfall arises from the fact that the parent's bank account may be linked to the college's tuition payment system, such that tuition refunds and financial aid disbursements may show up in the parent's account. Although the funds clearly belong to the student, and the parent may not even have access to the tuition account to see what is going on, the funds can appear to belong to the debtor parent. If the receipt of these funds is not disclosed to the trustee, the debtor's discharge is in jeopardy. The trustee might also seek turnover of the funds.

In this situation, it is prudent to unlink the parent's account from the tuition payment system, and run all tuition payments, refunds and aid disbursements through an account solely in the name of the student, before filing bankruptcy. If the parents are contributing to the tuition payments, they should make their checks payable to the student and run the funds through the student's account. And, of course, they should fully disclose such payments.