BANKRUPTCY

Is Our Home Protected if We File a Chapter 7 Bankruptcy Petition?

A guide to answering the most important question

By Robert L. Pryor

Debtor clients reluctantly choose a Chapter 7 bankruptcy solution to escape from the suffocating pressure of accumulated debt, compounded by massive interest charges. However, almost immediately after the realization that the debt can be discharged, a fresh start can be obtained and credit can be rebuilt, the next question becomes, which, if any, of his or her assets will be lost through the process? Especially in the counties of Nassau and Suffolk, where a major percentage of the potential bankruptcy candidates are owners of homes, the most critical question becomes – Is my home at risk? Not only is this question justifiably of monumental importance, but the consequences to both the attorney and to his client of providing the wrong answer cannot be overestimated. Stated differently, you do not want to be the attorney who tells his client his house is protected, only to find out that it is not protected; that the trustee intends to sell it and your client will be left homeless within months.

Up until relatively recently, the analysis began and ended with the New York Exemption Statute, CPLR § 5206, which has been incorporated into the bankruptcy exemption statute by virtue of the "opt-out" provision of the Bankruptcy Code, 11 U.S.C. § 522(b)(3)(A). Under this so called opt-out statute, individual states were authorized to create their own schedule of exemptions as an alternative to the enumerated federal exemptions. Consistent with that authorization, the New York Legislature enacted Debtor Creditor Law §

283.2., which as to a debtor's homestead, authorizes a debtor to claim the exemption available under CPLR § 5206. On June 4, 2009, CPLR § 5206 was amended to state as follows:

> § 5206. Real property exempt from application to the satisfaction of money judgments.
>
> (a) Exemption of Homestead. Property of one of the following types, not exceeding $150,000.00 for the counties of Kings, Queens, New York, Bronx, Richmond, Nassau, Suffolk, Rockland, Westchester, and Putnam . . . in value above liens and encumbrances, owned and occupied as a principal residence, is exempt from application to the satisfaction of a money judgment.

CPLR § 5206(a).

Thus, under CPLR § 5206(a), a debtor residing in Nassau or Suffolk County may exempt up to $150,000.00 of equity in his home. In most cases, the application of the statute is relatively straight forward. Thus, if a debtor owns a home in Nassau County that has a fair market value of $475,000.00, and it is encumbered by a first mortgage in the amount of $350,000.00, this results in a net equity of $125,000.00. Insofar as this net equity of $125,000.00 is less than the allowed homestead exemption of $150,000.00, the house is wholly protected from sale by a Chapter 7 Trustee *unless*, the trustee can net, after the sale of said property, sufficient funds to: (a) pay off the first mortgage, (b) provide first up to $150,000.00 of the remaining sale proceeds to the debtor, and (c) pay all closing costs, brokerage commissions, and costs and expenses of sale, and (d) yield a net recovery to creditors. Insofar as there was only $125,000.00 in equity under the foregoing hypothetical, the trustee would not be able to sell the home (insofar as there would be no benefit to the bankruptcy estate and the creditor body) and the home would be preserved for the benefit of the debtor and his dependents.

Recent history has manifested two alarming trends which, when taken together, create complications as to the application of the New York homestead exemption statute in bankruptcy cases, and create uncertainty as to a debtor's ability to preserve his home through the Chapter 7 bankruptcy process. One online reporter has noted that at the end of 2013, there were 9.3 million US residential properties that were "deeply underwater" at the end of 2013, down from 10.7 million in September of 2013, and 10.9 million through January 2013, but nevertheless an alarming amount in itself. The article explains that in this context, "deeply underwater" means that "the homeowner owed at least 25% more than the estimated market value of the property." [1]

At the same time, as of February 13, 2010, CPLR § 3408(a) was amended to impose the obligation upon a foreclosing mortgagee to engage in mandatory settlement conferences in residential foreclosure actions and 3408(f) was amended to require that "both the plaintiff and defendant shall negotiate in good faith to reach a mutually agreeable resolution, including a loan modification if possible." As a result of these amendments, as well as a concomitant general bottleneck in the court administration of foreclosure proceedings, it is not uncommon for foreclosure actions to take in excess of 2 to 4 years from start to finish. Thus under the current climate, a major percentage of homeowners filing for bankruptcy have substantial negative equity in their homes and are defendants in foreclosure actions that are protracted for long periods well beyond historical norms. This trend is quite beneficial to homeowners as it enables them to remain in possession of their homes for years, without paying their mortgage or taxes. In response, mortgagees are focusing on potential procedures to expedite the process and to limit their financial exposure.

Consider the following scenario. A mortgage holder is owed $400,000.00 on property that is worth $375,000.00. The mortgagee commenced a foreclosure action 18 months earlier, but the case is not progressing and it expects that it will take at least another 18 months for it to obtain a judgment of foreclosure and to conduct a foreclosure sale. Accordingly, the mortgagee is prepared to offer to the trustee in bankruptcy, appointed to represent the creditors in the mortgagor's Chapter 7 case, a "carve-out", *i.e*. a portion of the proceeds to which it would otherwise be entitled, in the amount of $40,000.00, if the trustee immediately sells the property through the bankruptcy process. There is facially a benefit to the creditor body from such an offer insofar as recovery of $40,000.00 for the benefit of creditors, after some level of administrative expense, would nevertheless yield a dividend, otherwise unavailable to pay creditors. Insofar as the mortgagee contends that the funds that are being made available to pay this dividend derive, not from the debtor's equity in the property, as there is none, but rather from funds otherwise available to the mortgagee on account of its secured claim, it is contended that the debtor is unable to claim a homestead exemption in the funds. Thus, the proposed sale of the property will dispossess the debtor and his family and they will receive no portion of the proceeds of sale to cover expenses caused as a result thereof. In such scenario, the debtor will generate no funds for moving expenses, a rental security deposit nor funds for rental payments on a rental property necessary to house the debtor and his family. It is in this context that it is quite understandable that a debtor would be more than irate that his counsel had not cautioned him as to this possibility.

The case of *In re Reeves,* 2011 Bankr. LEXIS 875 (Bankr. E.D.N.C. 2011), affirmed sub. nom. *Reeves v. Callaway* 2012 U.S. Dist. LEXIS 189722 (E.D.N.C. 2012), affirmed 2013 U.S. App. LEXIS 23358 (4th Cir. November 20, 2013) illustrates the potential pitfall awaiting an uninformed debtor.

In *In re Reeves,* 2011 Bankr. LEXIS at 875, the joint debtors (husband and wife) stipulated that the fair market value of their residence was $325,000.00 and that it was encumbered by a first mortgage lien in the amount of $195,500.00 followed by a federal tax lien in the approximate amount of $382,300.00. Insofar as the forgoing liens were greater than the fair market value of the property, the parties concluded that there was no equity in the debtors' residence. Notwithstanding, under North Carolina law, the debtors claimed a $60,000.00 exemption in their homestead.

The IRS and the Chapter 7 Trustee agreed to a sale of the debtors' homestead, with the IRS granting a "carve-out" of 30 percent of the net proceeds of sale, otherwise subject to the IRS lien, to cover allowed administrative claims with the remainder available, *pro rata*, to pay to unsecured creditors.

The debtors advanced several arguments, in opposing the sale. As it relates to this instant article, they contended that in light of their claimed homestead exemption, the first $60,000.00 was payable to them in advance of any other creditors (including administrative creditors)[2]. The bankruptcy court held that the amounts that were made available for distribution to administrative claims and unsecured creditors derived not from any equity in the property, as there was none, but rather it represented a portion of the proceeds available to the IRS on account of its lien and was therefore not subject to the homestead exemption. Accordingly, the court authorized the sale, both divesting the debtors from title and possession to their real property and precluding them from any entitlement to a portion of the proceeds of sale on account of their homestead exemption.

Debtors file for bankruptcy relief to protect themselves from the harsh effect of creditor pressure under state and otherwise available federal law. Under *Reeves,* the effect is to remove the debtor's from their home on a faster track than that otherwise available under non-bankruptcy law. Thus, as to the ability to remain in their home, as *Reeves* construed bankruptcy law, it punishes, as opposed to protects, debtors.

Second, the basic policy consideration underlying the various federal and state homestead exemption statutes is to provide either a homestead in which the debtors may reside through bankruptcy and thereafter or, in the alterative, sufficient funds to facilitate a fresh start to provide moving expenses, rental security deposits and other necessary funds to facilitate the continued maintenance of a roof over their heads. Clearly, then, *Reeves* frustrates the legislative objective by providing neither permanent nor temporary shelter to a Chapter 7 debtor seeking a fresh start.[43]

There is however, another interpretation of the facts underlying *Reeves*, and the common scenario it portrays. While the *Reeves* court endorsed the trustee's position that the funds freed up for the benefit of unsecured creditors constituted a portion of the secured creditor's collateral, and thus were gifted from the secured creditor, such a perspective does suffer from shortcomings. If we return to the original hypothetical where a mortgagee agrees to a "carve-out" to induce a trustee to sell a homestead in bankruptcy, it should be recognized that the "carve-out funds" were never available to the secured creditor. That is, the secured creditor would not have access to the funds absent the completion of the foreclosure process, at a substantial cost in time and money (legal fees, the accrual of interest, taxes and other charges). The trustee is conferring a tangible financial benefit to the secured creditor, in exchange for which the secured creditor is paying (or crediting) value. The transaction is very different than a gift, wholly unsupported by consideration.

In fact, the scenario is actually more closely akin to a "short payoff," where the mortgagee accepts less than is owed, to induce a mortgagor to sell his property, thus saving the mortgagee the time, expense and costs to be incurred in foreclosing the property.

3

The short payoff analogy gives rise to an alternative characterization of the "carve-out" payment. The effect of a short payoff is to effectively reduce the balance the mortgagee is prepared to accept in satisfaction of its mortgage. Therefore, it is not unfair to conclude any amounts paid in excess thereof, constitute equity, *i.e*., amounts available after paying encumbrances. If the amounts in excess of the mortgage are indeed equity, then they would be protected by the debtor's homestead exemption and not available to pay administrative, priority and unsecured claims.[3]

Under this analysis, any sums allocated in the *Reeves* case to the payment of unsecured claims would be subject to the debtor's homestead exemption.

Recent history has manifested a second related trend in addition to the "carve-out" scenario described above. Under this second trend, third parties offer a modest sum to Chapter 7 Trustees to acquire the bankruptcy estate's right, title and interest in and to a homestead, *subject to* all liens, claims and encumbrances, requiring only that the trustee deliver the homestead property free of occupancies. It would appear that the motivation for such an offer is to obtain possession of the home, so as to lease it to a tenant during the time it would take for the mortgage holder to complete the foreclosure process and to recover possession. If the offeror can use its position as owner and occupant (through its tenant) to negotiate a mortgage reduction thus creating equity, this would be an added bonus. Once again, the casualty of the process is the debtor, who has unexpectedly been divested of occupancy of his homestead as a concomitant to seeking a bankruptcy discharge.

This scenario is facially more objectionable than the "carve-out" scenario, because no argument exists that there is a "gifting" of the secured creditor's mortgage funds to the creditor body. Instead, it is relatively clear that the offeror is offering an amount in excess of liens to purchase the property. It is submitted that this is quintessential equity, i.e., value in excess of liens. Thus, if the debtor is entitled to all equity up to the amount of his homestead exemption, the funds benefit only the debtor and concomitantly there is no benefit to the bankruptcy estate. The alternative outcomes are either a) the court would disapprove the sale as providing no benefit to the estate, or b) the sale would be approved but neither the Trustee nor his professionals would be allowed any compensation or reimbursement from the debtor's exempt proceeds. See 11 U.S.C. § 522(k) (exempt property "is not liable for the payment of any administrative expense" with several exceptions not relevant herein).

Insofar as the only beneficiary of such transaction would be the debtor, is it hoped that the court would be sensitive to the debtor's position in making a cost-benefit analysis whether to authorize the sale, weighing the debtor's preference to receive exempt dollars verses the continued occupancy of his homestead. In practical terms, it is unlikely that the trustee would engage in substantial trustee work and legal work without compensation, and therefore, the most likely scenario is the sale would never occur.

In *In re Mannone*, Case No.: 14-70247-reg (Bankr. E.D.N.Y. May 20, 2014) (Grossman, J.), Judge Robert Grossman addressed this very issue. When faced with a motion to approve the sale of a homestead property as to which the Debtor conceded there was no equity, Judge Grossman held that “the price the Purchaser is willing to pay, not the Debtor’s schedules, determines the value of the Property.” Thus, an offer in excess of the existing mortgage debt was the measure of value; thus creating equity for the Debtor. Because the Debtor was entitled to claim as exempt any equity up to his available homestead exemption, the proposed sale conferred no benefit upon the bankruptcy estate, and Judge Grossman refused to approve the sale.

In *In re Nestor W. Payne*, Case No.: 12-75463-ast (Bankr. E.D.N.Y. May 30, 2014) (Trust, J.), Judge Alan Trust when confronted with a closely analogous fact pattern reached the same result, albeit under different analysis. In essence, Judge Trust held that the Debtor’s right to possession existing under applicable law was entitled to adequate protection under 11 U.S.C. § 363(e). Unless and until the Trustee could compensate the Debtor for his potential loss of possession otherwise available under state law, the Trustee was unable to obtain Court permission to oust the Debtor and to interfere with his possessory rights.

Finally, the argument that a "carve-out" from a mortgage to pay unsecured creditors is impermissible insofar as it bypasses the debtor's prior right to a homestead exemption may draw support from a broad interpretation of the Second Circuit decision in *Dish Network Corp. v. DBSD N.Am., Inc.*, (*In re DBSD N.Am, Inc.*), 634 F.3d 79 (2d Cir. 2010), which held that the gifting of a portion of its collateral by a secured creditor to equity security (shareholders) holders, thus, bypassing intervening unsecured creditors, violated the Chapter 11 "absolute priority rule" and thus was invalid.[4] In the current scenario, there is no question that if the debtor is entitled to a homestead exemption, it is paid out of the first proceeds of sale before both priority (including administrative) and unsecured claims.

Thus, the argument would continue that the effect of the "gifting," clearly resulting in the deprivation of the debtor's homestead exemption, is inimical to the statutory scheme and the primacy of the debtor's homestead rights in that scheme.[5] In other words, the right of debtor and his dependants to continue to occupy his home under state law, should not be overridden by the payment of a minimal (or more than minimal) distribution to creditors.

In light of the foregoing, debtor's counsel might obtain traction in opposing a proposed "carve-out" sale of the debtor's homestead by taking the position that the proposed "carve-out" represents nothing more than a short payoff, and accordingly that the first funds received by the bankruptcy Trustee are to be paid to the debtor on account of the available homestead exemption. Followed to its logical conclusion, the sale would not free up funds to pay the Trustee, his professionals, and unsecured creditors. The effect would largely preclude the trustee from the sale of the debtor's homestead. In such event, the debtor's right to continue in his homestead, to defend a foreclosure action, to possibly work out a modification arrangement, and in either case to utilize his homestead for a protracted period of time, could all be accomplished. In such event, the filing of a Chapter 7 petition by a debtor would not be coupled by the unanticipated consequence that the Debtor and his family would be left on the street, converting the intended refuge of bankruptcy protection into an unintended nightmare.

In any case, a prudent attorney should lay out to his prospective client the potential pitfalls of a Chapter 7 filing so that a debtor is at least cognizant of the risk to his homestead in determining to file a bankruptcy petition.

Note: Robert L. Pryor is a partner and founder of the Westbury law firm of Pryor & Mandelup, L.L.P., concentrating in bankruptcy, reorganization and insolvency-related litigation. Mr. Pryor is past Chairman of Bankruptcy Committee of the Nassau County Bar Association. He served as Law Clerk to the Hon. C. Albert Parente, United States Bankruptcy Chief Judge, Eastern District of New York. Additionally, he has served as a member of the panel of Trustees for the Eastern District of New York from 1985 until present. He lectures on behalf of organizations including the St. Johns Tax Institute, New York State Bar Association, Nassau County and Suffolk Academies of Law, NCCPAP, National Business Institute and as a guest lecturer at Touro Law School.

---

[1] www.trulia.com/blog/manu_1/2014/01/underwater_residential_properties_dropping.

[2] The argument was designed to subvert the sale because if all available funds were paid first to the Debtors, neither the Trustee nor his professionals would be paid and could not go forward with the sale. The argument, ignores, however, the fact that irrespective of a "carve-out" agreement, a Trustee is authorized by 11 U.S.C. § 724(b), to sell property encumbered by federal and state tax liens (but not *ad valorem* taxes) and to pay from the first proceeds administrative and priority (but not general unsecured) claims.

[4] On February 3, 2014, the Sixth Circuit reached the same conclusion as the *Reeves* Court in *Baldridge v. Ellmann* (*In re Baldridge)* 553 Fed. Appx. 598, 599 (6th Cir. 2014), that the Debtor's homestead exemption did not attach to a "carve out" from a mortgagee's secured claim, rejecting the Debtor's argument that the sums paid to the estate were on account of the Debtor's "foreclosure related right of redemption," and therefore subject to the homestead exemption.

[5] Obviously, the analysis is different in a sale under 11 U.S.C. § 724(b) to the extent the funds are made available from a state or federal tax lien only to pay administrative and priority claims as expressly provided by statute.

[6] In dicta, *Dish Network* distinguishes its holding from *In re SPM Mfg. Corp.*, 984 F.2d 1305 (1st Cir. 1993). In *SPM Mfg. Corp.*, the First Circuit approved a settlement by and between

a secured creditor and creditors committee where under said entities would share in certain proportions amounts recovered from the liquidation of collateral, bypassing the priority claim of the taxing authorities in so doing. The court justified such a deviation from the distribution scheme set forth in 11 U.S.C. § 726 by stating "However, the distribution scheme of Section 726 . . . does not come into play until all valid liens on the property are satisfied." (984 F.2d at 1312.)

[7] To the extent that *Reeves* involved in part, the allocation of funds to unsecured creditors from funds otherwise payable to the taxing authorities and which by statute may expressly be utilized to pay administrative expenses, under 11 U.S.C. § 724, it is to that extent, factually inapposite. However, to the extent that it goes further in using “carve out” funds to pay unsecured creditors, it enters new territory not covered by 11 U.S.C. § 724.