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COMMUNITY UPDATE

INSIGHTS, ANALYSIS & IDEAS FOR COMMUNITY LEADERS SINCE 1980

“Unit owner ‘X’ filed for bankruptcy . . .

now what?”

Bankruptcy is one of the most well known, yet least understood areas of law. It's not surprising that individual filings are up the past few years.

One of the things that makes bankruptcy law so intimidating is that it blends a heavily worded federal statute - the Bankruptcy Code - with state law, which differs from one state to the next. Bankruptcy cases are handled by special divisions of the federal district courts, and they are governed by their own set of procedural rules, which makes them seem even that much more foreign.

But, like most unfamiliar things, bankruptcy is not as bad as it first seems. In reality, there are only a few important principles that underlie all of bankruptcy law that, once understood, can help pull the cloak from most simple bankruptcy related questions.

The basics:

The United States Bankruptcy Code is found at Title 11 of the United States Code. Since the first Bankruptcy Act of 1898, the applicable federal bankruptcy statute has undergone a number of changes, but, through it all, federal bankruptcy law has consistently sought to balance two overriding and competing concerns: creditor protection and debtor relief.

The Bankruptcy Code helps creditors by providing a fair and controlled environment for the settling of the debtor's financial affairs and the distribution of any valuable assets. At the same time, it provides debtors relief from financial failure and affords them a "fresh start" by forgiving certain debts upon completion of the bankruptcy case. For instance, while the automatic stay imposed by Section 362 of the Bankruptcy Code stops all efforts to collect debts from a debtor that files bankruptcy petition, thereby giving the debtor an opportunity to "breathe," it actually protects creditors as well by preventing a "race to the courthouse," whereby only the creditor that gets to the debtor's assets first gets paid. Even the bankruptcy discharge, which extinguishes certain types of debt at the conclusion of the bankruptcy case, protects creditors by exempting (i.e., carving out) certain types of debt from discharge and by denying certain debtors discharge as a result of dishonest or uncooperative behavior.

Although the policy objectives in all bankruptcy actions are the same, there are actually two distinct types of bankruptcy that apply to individuals and corporations: liquidations and reorganizations. Liquidations are governed by Chapter 7 of the Bankruptcy Code, while reorganizations are governed by Chapter 13 (available only to individuals) and Chapter 11 (available both to individuals and corporations). Because most

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Lisa Magill, Esq., Editor
Marilyn Perez-Martinez, Esq., Assistant Editor
3111 Stirling Road, Fort Lauderdale, FL 33312
www.becker-poliakoff.com

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unit owners are individuals, the most common types of bankruptcy for debtors of community associations are Chapter 7 and Chapter 13. Chapter 13 requires that the debtor complete a plan for either 3 or 5 years, during which the debtor pays all of her disposable income to creditors pursuant to a schedule, before it will provide the debtor a discharge.

Chapter 7 bankruptcy relief is only available to debtors who earn below a certain income threshold, known as the "means test" and it provides the debtor with a fresh start.

<u>Collection Efforts Impacted by Bankruptcy</u>

What do you do when a notice arrives in the mail indicating that a delinquent unit owner has filed for bankruptcy? (The best thing to do is to call the association's Collection/Foreclosure attorney to discuss exactly how the filing will impact the association's efforts to collect the delinquent debt.)

However, there are other acts that the association can take that may be in violation of the automatic stay in ways that are not as obvious.

<u>Automatic Stay:</u> In most cases all collections efforts will have to stop temporarily. This is because the automatic stay prohibits almost *any* act that has the effect of coercing a debtor to pay a pre-petition (i.e. pre-bankruptcy) debt. The law prohibits "willful" violations and provides for "actual damages, including costs and attorneys' fees, and, in appropriate circumstances, punitive damages" for violations of the automatic stay. If only one of several unit owners owning the same unit files for bankruptcy, the automatic stay will - at least in Chapter 13 cases - prevent collection of assessments related to that unit against *all* of the owners under the co-debtor automatic stay found in Section 1301 of the Bankruptcy Code.

So, at this point the association must cease efforts to collect pre-petition debts directly from the debtor such as sending demand letters, filing a lien or continuing the prosecution of a lawsuit against the debtor. ***However, there are other acts that the association can take that may be in violation of the automatic stay in ways that are not as obvious.*** For instance, what if the unit owner's use or voting rights had previously been suspended, do they have to be reinstated? After all, the "act" of suspending such rights was done before the bankruptcy. While the question has not been settled by an appellate court, the answer, however, is likely "yes - the rights must be reinstated," or, at the very least, the suspension cannot be enforced. At least that is what Judge Robert A. Mark of the Bankruptcy Court for the Southern District of Florida said in *In re: Louis Fulop*, Case No. 10-38024-BKC-RAM, where he handed down an order requiring a condominium association to reinstate the debtor's use rights. The judge reasoned that the purpose of the suspension was to compel payment, and that continuing to enforce it by preventing the exercise of the unit owner's rights (which is an act in and of itself) perpetuates that coercion in violation of the automatic stay. To avoid a finding that your Association has violated the automatic stay through an indirect act such as the suspension of rights example, make sure to speak to the Collection/Foreclosure attorney the moment an owner has declared bankruptcy to not just discuss the plan for the future but to also address any actions taken against that owner before the bankruptcy.

Want to Continue Your Collection Efforts? The automatic stay does not have to be the end of all collection efforts against the unit owner. Section 362(d)(2) of the Bankruptcy Code explicitly provides for relief from stay of actions against property if the debtor:

- does not have any equity in the property, and,
- in the case of Chapter 11 and 13 reorganizations, if the property is not necessary for an effective reorganization.

In order to obtain the relief, the association must file a motion in the bankruptcy case. The association has the burden to show the lack of equity in the property, while the debtor has the burden of showing that the property is necessary for reorganization, if applicable. If relief is granted, the association will then be able to pursue the recording and/or foreclosure of a claim of lien against the property. In that case you will not obtain a personal judgment against the unit owner/debtor. If you want the property sold and take possession, this process is much faster than waiting.

How long does it take? There are a number of factors, i.e. liquidation vs. reorganization, the type and number of assets in the debtor's estate, and the number of creditors.

In Chapter 7 cases, the court will usually promptly enter a discharge once the time period expires for objection to the discharge, which typically occurs about four months after the date the debtor files the bankruptcy petition. The Chapter 7 discharge basically "discharges the debtor from all debts that arose before the date of the order for relief." However, there are many exceptions, such as taxes, child and marital support obligations, and student loans. Unfortunately, community association assessments and other debts owed to condominium and homeowners associations are not on the list.

A Chapter 13 discharge will likewise extinguish the personal liability on most pre-petition debts. However, the debtor is not entitled to a discharge until successfully completing the Chapter 13 plan, which itself must first be confirmed by the Court.

Unless the association's lien was "stripped" through special action in Chapter 13 bankruptcies, the association still has the ability to lien for all unpaid amounts, whether they accrued before or after the filing of the bankruptcy and then obtain an *in rem* foreclosure.

Conclusion

It is unfortunate that bankruptcy is often the subject of abuse by debtors simply seeking to hinder/delay creditors or that otherwise does not intend to obtain a discharge. Even when bankruptcy is pursued in good-faith, provisions in the Bankruptcy Code such as the automatic stay and the debtor's discharge, have the potential to create liability for creditors. As a result, condominium and homeowner's associations should be aware of at least the basic implications of a bankruptcy filing by a delinquent unit owner so that they may avoid some of the more common pitfalls associated with dealing with a bankrupt debtor. But, as the saying goes, "a little knowledge can be a dangerous thing" therefore, always make sure to immediately reach out to the association's attorney upon receiving any bankruptcy related documents regarding a delinquent unit owner.

Skin *in the* Game

Some New Owners Need Incentive To Pay Assessments

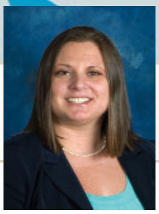
By Bradley Foster Rothenberg, Esq.
brothenberg@becker-poliakoff.com

If your community is like many, the residents pay high assessments to make up for those owners who don't pay their share. Many of the non-paying owners are in various stages of bank foreclosure. Often it doesn't make sense for the Association to foreclose on a unit that is under water. In other words, the unit owner owes the bank more than the unit is actually worth. As assessments rise, foreclosures drag on, and the Board wonders…How did we get into this mess? The answer is, purchasers never had any skin in the game. In the height of the real estate bubble, banks lent up to one hundred four percent (104%) of the purchase price to buy real estate. People borrowed more than the value of the real estate they were purchasing to finance the unit. They had no equity from day one. Then, the market declined. It went down ten percent (10%), then twenty percent (20%). People were paying without any chance of recovering their investment, until they realized they had never really invested at all. The bank had invested in the unit, but the owner was merely renting the unit, because he had no skin in the game. He just walked away from the unit and never looked back.

What can we, the condominium, homeowners, or cooperative association do to protect ourselves from this problem reoccurring? What if the banks forget the past and lend unthinkable amounts to persons to buy units they cannot afford, exposing the Association to the same risk?

A financing limitation combined with a mortgage cap is an excellent tool to insulate a community from a collection/foreclosure crisis. It limits the amount a purchaser can finance when buying a unit. Even if the bank is willing to loan a purchaser one hundred four percent (104%) of the purchase price, your community could limit the loan to ninety or even eighty percent of the purchase price. This forces the purchaser to put cash down to buy a unit in your community. Does this limit the pool of purchasers who can buy a unit in your community? Of course it does! **It limits purchasers to those who can afford to buy a unit in your community**. It protects current residents from future collections and foreclosures, because all new purchasers will have skin in the game. It also prevents the purchaser from borrowing money against the unit after the closing, if the loan to value exceeds the cap. Otherwise, owners would put down twenty percent (20%) only to borrow it back the day after closing in a home equity line of credit (HELOC). Here's a promise, if you implement a financing limitation combined with a mortgage cap, the real estate agents in the community will go crazy. They'll tell you that owners will be unable to sell their homes, there will be no buyers for your community, and property values will plummet. Respectfully, I disagree. The only thing that will plummet will be the number of collections and foreclosures and maybe even the cost of assessments. With skin in the game, owners cannot afford to walk away. They will beg, borrow, or steal to protect their investment. The result is a community where everyone pays their fair share. That's all we want, isn't it?

CAN YOU TREAT TENANTS DIFFERENTLY?



By Sarah Spector, Esq.
sspector@becker-poliakoff.com

Distinctions in Rulemaking Powers

Often times Boards are given authority to adopt rules regulating use of both the units/lots and the common elements/areas without membership approval. However, this rulemaking authority is not unlimited. Rather, the Fourth District Court of Appeals, in Beachwood Villas v. Poor, 448 So.2d 1143 (Fla. 4th DCA 1984), established a "test" for determining whether a Board-made rule is enforceable. One test that a rule must "pass" is that it is "reasonable" and not discriminatory.

The question of whether a rule is discriminatory is often raised when an association proposes a rule that seeks to treat tenants differently from owners. We routinely see this when the issue of pet ownership is raised. Many associations that allow owners to have dogs and cats seek to prohibit tenants from having anything more than quiet, contained fish. The reason frequently cited for such a prohibition is that tenants do not have the same interest in maintaining the property as owners do; while owners are interested in keeping up the appearance of the community and, as such, are more likely to clean up after their animals, tenants do not care because they do not hold an ownership interest. Similarly, owners do not want to allow their dog's barking to annoy their neighbors because they will be living next to these people for years to come, but tenants can vacate the premises at the end of the lease term and, as such, are not as concerned with maintaining a congenial relationship with those around them.

While there is not a lot of case law addressing the reasonableness of proposed rules, we believe there is a legitimate basis to distinguish between owners and tenants. However, it is first important to verify that Association's governing documents do not include a prohibition against such a distinction. While it is not a common provision, some governing documents specifically provide that owners and tenants shall be treated equally. Obviously, this would preclude an association from, for example, adopting a rule that would allow only owners to have pets.

Provided that the governing documents do not contain such a provision, we would recommend that the Board, when considering amendments to rules that would treat tenants differently from owners, take certain steps to explain why it is taking this action. Specifically, it is advisable for the Board to state on the record (i.e., in the minutes or a Resolution) the reasons for making this distinction, including but not limited to the observed differences between owners and tenants. And, as is always the case, after adoption of the rule, the association must take care to enforce it uniformly against all tenants so that its validity is not later called into question.