By: Brad Geisen

IS CHAPTER 7 BANKRUPTCY BROKEN?

Does the current process deny debtors and creditors their rights?

According to the U.S. Courts website, the fundamental goal of the Federal bankruptcy laws enacted by Congress is to give debtors a financial "fresh start" from burdensome debts and provides for "liquidation" in a Chapter 7 filing—the sale of a debtor's property and the distribution of the proceeds to creditors.

THE QUESTION IS, DOES IT?

Bankruptcy was created to give individuals a legal vehicle to settle debts or negotiate manageable terms. In general, trustees do a great job working with debtors to resolve the vast majority of their debt. However, when real estate is involved, the options outlined in the federal bankruptcy laws are rarely followed, creating greater burden, hampering, or making it impossible for debtors to truly receive a "fresh start."

Bankruptcy law is well defined and offers several solid solutions for both the debtors and creditors, but in most cases, these options are never allowed. It seems hard to believe, but if you dive into the process and the structure of how cases are administered, both the law and the intent of the law take a back seat to reality.

In Chapter 7 bankruptcy, a trustee is appointed to administer the case. The primary role of the U.S. Trustee Program is to serve as the "watchdog over the bankruptcy process." As stated in the Mission Statement: The mission of the United States Trustee Program is to promote the integrity and efficiency of the bankruptcy system for the benefit of all stakeholders—debtors, creditors, and the public.

For this service, the trustee receives a fee for administering the estate and a percentage of any assets sold.

Although the Trustee must be fair to the debtor, their interests aren't always aligned.

The Trustee Handbook states: "The Chapter 7 Trustee is the representative of the estate. 11 U.S.C. § 323(a). The Trustee is a fiduciary charged with protecting the interests of all estate beneficiaries—namely, all classes of creditors, including those holding secured, administrative, priority, and non-priority unsecured claims, as well as the debtor's interest in exemptions and any possible surplus property."

The statement seems pretty straightforward and relatively simple, but where does everything go wrong?

There are several reasons why a trustee might decide to abandon a property from the bankruptcy. Suppose the property sale didn't bring enough meaningful value to the estate, the property had title issues, or they could not generate meaningful compensation for the trustee's time spent working on the case.

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Over time, regulation, process, and interpretation have turned the bankruptcy process into a black hole for creditors and the end of the road for debtors, resulting in a lose-lose for all stakeholders.

LET'S BREAK IT DOWN:

When an individual files Chapter 7 bankruptcy and they own real estate, they either "retain" or "surrender" the property.

If the individual elects to "retain," they intend to keep their home and negotiate or eliminate the other debts. However, if they chose to surrender, this is where things go astray.

When a debtor surrenders a property, the trustee becomes the legal administrator/seller and has a fiduciary to sell the property or give it back to the secured creditor to settle the debt. In most cases, this does not happen.

If the trustee sells the property, then they are fulfilling their duty to both secured and unsecured creditors, and will apply proceeds from the sale to unsecured creditors (medical bills, credit cards, etc.) in the estate.

Alternatively, the trustee can choose to abandon the property, which removes it from the bankruptcy estate. There are several reasons why a trustee might decide to abandon a property from the bankruptcy. Suppose the property sale didn't bring enough meaningful value to the estate, the property had title issues, or they could not generate meaningful compensation for the trustee's time spent working on the case.

Often a trustee shies away to avoid scrutiny from governing authorities such as the United States Trustees' office, which regulates the trustees' activities. Also, their local judge in the district may have a different view on selling assets because they may be over-encumbered assets.

These are all valid issues which stem from a broken system. Trustees, creditors, and even creditors' counsel become adversarial rather than working together to align all parties' interests for a positive outcome.

Most debtors and their legal counsel believe that once an asset is surrendered, they are off the hook. The onus to resolve the lien falls back on the debtor. The secured creditor has few options when this happens, and if the debtor does not workout financial arrangements with the creditor, they mainly file foreclosure and eventually take possession of the property. This creates emotional turmoil and long-lasting financial hardship on the debtor when their intent was to workout a solution for the surrendered property.

To make matters worse, a foreclosure has a much more significant impact on a debtor's credit future. Bankruptcy or a short sale will impact a credit score about 85–160 points (higher scores have the most significant impact), but this is only short-term, providing the debtors the ability to reestablish their credit in 18-24 months and the ability to buy another home.

Foreclosure, on the other hand, stays as a negative mark on a credit report for seven years, preventing the debtor from housing credit and much more. Even after that time passes, a new mortgage will still be at a much higher rate.

If a trustee abandons the property and the real estate lien is not resolved while in bankruptcy, the debtor loses the benefit of bankruptcy, suffering total financial hardship, and robbing the debtor of the ability to receive that "fresh start" that is the goal of a bankruptcy.

For the secured creditor, selling property in bankruptcy versus foreclosing saves an average of $49,000 on a $250,000 home—a preferable outcome for a creditor to save money and complete a nonforeclosure outcome, but when the secured creditor is denied their right to have the home sold in bankruptcy the mortgage creditor suffers that loss. The courts will argue that they have remediation options outside of bankruptcy. However, since selling in bankruptcy is a much better option and elected by the debtor to have the home sold; not allowing this sale to occur creates significant financial hardship for both the debtor and creditor. This is not the intention bankruptcy law was intended to provide.

Why does this happen?

Well, several issues lead to this result.

THE ROLE OF THE TRUSTEE

The trustee is commissioned to administer the debtor's estate and receives $60 for this service plus a percentage of funds distributed to other creditors in the estate.

Trustees are appointed by and report to "The Office of the United States Trustee" (UST). The UST is an executive branch agency that is part of the Department of Justice. Its responsibilities include monitoring the administration of bankruptcy cases and detecting bankruptcy fraud.

Trustees are under constant examination from the UST's office and can be sanctioned for any malfeasance, both real or perceived. The focus is primarily on potential fraud from the trustee receiving fees for the services they

provide and rarely is the focus on the benefits to the debtors and creditors. This perceived scrutiny that comes with the sale of an asset often discourages a Trustee from completing their fiduciary duty.

COURT DISTRICTS

Bankruptcy law is federal law; however, it is governed by approximately 94 court districts across the country and differs on its application from district to district.

Bankruptcy law clearly defines how real estate assets are sold in section 11 U.S.C. § 363. The law goes into great detail for over-encumbered assets, giving the trustee several options depending on the circumstances and the consent of all stakeholders. Today, there are several districts that "do not allow" the sale of "short sales" (over-encumbered assets) either by the UST's office or the judge.

The reasons that short sales are not allowed in certain districts range from differing applications of the law on the transactions. The most common misconceptions are that these transactions are fraudulent and don't help the debtor, short sales never help the creditor, or that these transactions will only benefit paying professionals and the trustees. These misconceptions by the courts and the trustees are at the heart of the issue. In a proper 11 U.S.C. § 363 transaction, none of these generalizations are founded.

This makes you question if the law allows debtors and creditors their rights under section 11 U.S.C. § 363, why are they denied court approval for the sale if they abide by the rules governed by the law?

GOOD QUESTION?

Where this doesn't make much sense is when a debtor elects to surrender their property to be sold and the Secured Creditor (mortgage servicer) has agreed to accept a short payoff, and they agree to pay the trustee a carve-out fee to administer the sale, creating meaningful value to the estate and unsecured creditors. This follows Bankruptcy Code, yet the UST or judge denies the sale. Doesn't that violate their rights?

The law is also clear that when selling fully encumbered property, the trustee must administer the sale to avoid a diminution of funds otherwise available for unsecured creditors, 11 U.S.C. § 704, 28 U.S.C. § 586. The trustee has a fiduciary duty to ensure the law is followed and should sell an asset to settle the debt to protect and preserve funds available to the unsecured creditors. However, this rarely ever happens as the system is broken. Bridging the gap between mortgage servicers, their counsel, and trustees results in a far better outcome for all parties involved.

Unfortunately, the current process to administer a case rarely allows debtors and credits the option to exercise their rights, creating greater losses and hardship.

So, how do we fix the process to ensure debtors and creditors can exercise their rights and utilize bankruptcy for the benefits it is intended to provide? It seems this is never a topic for discussion and why most creditors consider bankruptcy as a "black hole."

It might be time to reassess and improve the process.

Some potential solutions might be:

1. Modifying the bankruptcy trustee's compensation to ensure the requirements in bankruptcy are fulfilled.
2. Having a different focus from governing authorities to ensure the law is followed and not focused only on fees and compensation.
3. Ensuring that when all parties consent and are within the law, they have the legal right to proceed with a sale.

Bankruptcy is one of our legal rights and one of the greatest benefits of our financial, legal system. Over time, regulation, process, and interpretation have turned the bankruptcy process into a black hole for creditors and the end of the road for debtors, resulting in a lose-lose for all stakeholders.

IS IT TIME TO FIX THE PROCESS AND RESTORE THE RIGHTS OF DEBTORS AND CREDITORS?

We have come a long way since we started on this mission, but there is still a long, long way to go. Today, there is a large portion of the country where trustees will not entertain a "short sale" in bankruptcy even though the trustee has a fiduciary responsibility to administer the sale. Ultimately, the debtors and creditors should have the legal right to request the sale.

Brad Geisen, CEO of BK Global, a bankruptcy solution provider, is a 35-year veteran of the default real estate industry and a serial entrepreneur, always focusing on creating smart solutions with better outcomes. He is known for creating online real estate solutions such as Foreclosure.com, HomePath.com, HomeSteps.com, TaxLiens.com, HUDHouses.com, and many more. He developed and ran a pilot program for HUD, which became the highly effective HUD M&M Program. Geisen created the first online offer management platform, which has become the industry standard used by mortgage servicers and the GSEs.