

Bankruptcy Options in a Divorce Setting

An Overview by John C. Renzi

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Divorce Debts may be best addressed with a Bankruptcy. *Or not.* This crucial question exists, but there is no simple answer. The existing debts may be both extensive and accumulated when the parties were together. That indebtedness may appear to have only been able to be serviced in the past. A real question would arise as to future ability to pay. It seems to logically follow that, with there being two separate households created, a Bankruptcy would be a beneficial tool in avoiding the underlying debt as well as any corresponding need to allocate payment.

Upon discharge, the debts would be gone; and the divorce attorneys would be free to fashion a far different decree. The removal of any need for servicing of past debt with the resultant freedom to effect separate residence and provide for the minor children would impact both parties' quality of life. Child support can be more readily paid; and children's expenses and their activities can more easily be allocated and afforded. There would be no need for any indemnification. Each party would be able to get on with their life to the exclusion of the other.

The mere existence of debt, no matter how sizable, however, does not dictate the viability of a Bankruptcy. Income and the number of dependents serve the first area of concern. Assets and their ability to be exempted from creditor reach is another issue. There is also the question of impact of non-filing parties, who may also be responsible for a particular debt. Finally, there is the issue of what is being accomplished through the filing? Are the debts, or a meaningful portion thereof, being discharged? Is the client(s) life being enhanced?

The following issues are also explored at greater length per the link below:

- Means Test – Implications, when needed, and impact on a Bankruptcy.
- Debts – Differences between secured, priority, unsecured, and non-dischargeable.
- Assets and reaffirmations versus no reaffirmations.
- BK7 – What is to be gained? At what Cost [e.g. any limitations encountered]?
- BK13 election: Chapter 7 not available or feasible, desire for a reinstated mortgage, a potential debtor(s) is over-leveraged or appears to be asset-rich/cash poor.

For a broader look at these and other general questions, please see our website's FAQs at www.jprlaw.net.

Means Test – Implications, when needed, and impact on BK:

For all *consumer* Bankruptcies, this calculation is needed. The major exception being for business-driven personal Bankruptcies.

Where applicable, there is a 6-month look back period [the CMI period] as to wages and income earned. This calculation includes maintenance, but not Social Security. It also can include bonuses as well as contributions by third parties. Depending on the number of dependents, the total amount can vary. As of May 1st, the maximum amount for 1 person is \$54,238.00 per year; for a household with 4 people, the amount becomes \$98,603.00 annually. The party considering Bankruptcy has the 6-month total doubled, which may (or may not) be below the stated ceiling amounts. If below, a Bankruptcy 7 can be filed, *provided* a Credit Counseling Certificate is obtained.*

Should the income be computed to be over this limit, a rebuttable presumption of abuse is created. This can be rebutted through the completion of the Means Test (but a Credit Counseling Certificate is still needed). For example, 2 people may have the same initially deemed “excessive” income, but one has mandatory pension withheld, pays a large amount for medical insurance and other insurance; and these obligations are coupled with a high car and house payment. The result for this particular person may be the rebuttal of the presumed abuse. Hence, a Chapter 7 can then be filed. Since there are other factors, such as child support and taxes, it is best for a thorough review by a competent Bankruptcy lawyer.

Should the presumption not be entirely rebutted, a 60- month Chapter 13 is mandated. However, the required payments may still only be cents-on-the-dollar, whereby a 5-year Bankruptcy plan resulting in a debt-free scenario may be advisable and incorporated into any Decree.

- * The completion of the statutorily mandated Credit Counseling is required in all filings. This can be done on-line or in-person, but should be completed the *day prior* to filing. A list can be obtained from the office.

Debts defined as secured, priority, unsecured, non-dischargeable

A secured debt is one that the Creditor has collateral for the loan. Examples would be houses and cars. Sometimes furniture, carpeting, and the like are secured obligations to the surprise of the client. This category of debts, an example of which is the person’s car note, can be reaffirmed, *provided* there is a positive budget filed. If, however, this is for the jointly purchased car that is not to be possessed by the Debtor, the underlying debt can be discharged (as to this party to the

joint transaction) with any payment to be the requirement of the other party on the Note, whose vehicle it is. In a divorce setting, this avoids the need for indemnification as the bankrupting party is relieved by law of any payment obligation through the discharge.

Priority debts are usually found in past due taxes owed. These debts may not be subject to discharge. There may be some reduction made, such as discharged interest. A detailed, debt specific consultation with a Bankruptcy attorney is needed to review the matter more closely. However, it is likely that payment of this debt will need to be expressly addressed in the Decree.

Credit cards and medical expenses are examples of general unsecured debts. These debts can be discharged in a Chapter 7 and/or paid as low as 10% in a Chapter 13, where all creditors are included and have no ability to opt-out. No allocation is, therefore, needed in the Decree. Again, there are exceptions for fraud, recently incurred debt, and the like. A consultation with a knowledgeable Bankruptcy attorney is, therefore, recommended.

Assets and reaffirmations versus no reaffirmations

It is common to hear that either a house, which is to be kept, or a vehicle, for which a payment is made timely and easily, are to be excluded from the Bankruptcy. This is wrong. The filed petition requires the identification of *all property* (i.e. the house and/or the vehicle) and the listing of *all indebtedness* (i.e. the underlying Mortgage and/or Note).

This does not mean all is lost with the mere listing of the property &/or the debt on the Bankruptcy. This does, however, presume any asset listed will be valued within the amount of the secured debt and the authorized exemptions, so there are no Assets for the Bankruptcy Trustee to administer.

Per statute, there is to be an election made regarding secured indebtedness. The Petition contains a Statement of Intent form to be completed by the Debtor. The collateral is to be redeemed at present value, reaffirmed per the existing Note, or surrendered. A final option of “other” is listed.

An example of “other” can be the designation of a vehicle possessed by another party, whereby the intent would be to allow the discharge and surrender the Debtor’s possessory right, but note payment is still exists and is to be made by the other signatory, who possesses the vehicle. This designation can also be used for a house, because there is a Mortgage and a Note. The intention would be to allow the Note to be discharged (and thereby avoiding any future personal liability), but honor the Mortgage, because the unaffected lien remains on the house.

For a vehicle, the usual process is to secure a reaffirmation with the creditor. There is a separate agreement that is filed with and reviewed by the Court. The Debtor promises that, in return for

continued possession of the vehicle, it will be kept insured and payments will be timely made. If the Debtor fails, the BK7 is of no effect, the vehicle can be repossessed with the Debtor again liable for any resulting deficiency. Despite client concerns, no creditor has ever refused to enter into such an agreement by asserting the return of the vehicle.

This is a complicated area of law and application, but the foregoing does provide an overview of these issues. There are other secured items, such as fences, furniture, carpeting, and electronics. These items may be addressed via return/surrender or negotiation resulting in a reaffirmation to value for a reduced (&/or no interest) payment. This issue is best discussed with a Bankruptcy attorney, who can review the documents and explain the resulting options.

Chapter 7 Bankruptcy: What is to be gained? At what Cost [Limitations encountered]?

There are debts that should be discharged in the eyes of the attorney. However, a client may view a \$850.00 monthly car payment as “manageable.” There may also be no client acknowledgement that the debt owed greatly exceeds the underlying collateral’s value. As such, the client may seek a reaffirmation of the debt that the attorney thought would be discharged with the property surrendered. Since a positive budget is needed to reaffirm, it is best to resolve these matters early in the representation and pre-filing.

Similarly, there may be some assets, such as a vehicle, that exceeds the allowed exemptions. For example, the client may focus resources on the payment of this debt, whereby the vehicle is owned outright. There may be a value of \$6,000 to \$7,500.00, but the exemption in Illinois is only \$2,400. Although portions of 1001(d) [known as the “wild card” exemption] can be used, the fair market value may exceed these exemptions and place the vehicle at risk in a BK7 of requiring it to be turn-over to the Trustee for the Estate. This, in turn, may necessitate a BK13.

The key is the realization that Illinois tends to be a dollar specific exemption state. Pension and work comp. are the exemptions as they are fully exempt from the Estate and creditors. A residence, however, is not automatically exempted, there is \$15,000 homestead awarded to each owner. As noted above, a vehicle receives only a \$2,400.00 exemption. All furniture, electronics, deposits, and the like are placed within the \$4,000.00 exemption. Since this valuation is that of a depreciating schedule, not a replacement costs, most people are able to fit within this exemption.

The potential debtor may, however, be faced with a dilemma. The “cost” of assets to be turned-over may be too great when compared to the “benefit” in obtaining a discharge of indebtedness.

The client may determine a Chapter 7 filing not to be a viable option, but a Chapter 13 may present an option worth pursuing.

Chapter 13 election:

This is commonly referred to as a “wage earner’s plan” and another option for the Divorce attorney. The advantage here is that, while still binding all creditors, no Assets are lost. The key is that future income is used to provide creditors with what would have been received in a Chapter 7 liquidation. In simple terms, a \$10,000 asset requires a payment of \$10,000 (plus Trustee and attorney fees) over the length of the Plan. However, the CMI [because of an finding of abuse] requires 60 months of duration and may set the minimum payment needed to unsecured creditors, whereby each matter requires an independent review by a knowledgeable Bankruptcy attorney.

The disadvantage to this is that a joint filing may be required and the Decree will be forced to address this matter. For instance, the monthly payment may be split equally between the parties *OR* one party will receive some other consideration (i.e. a reduced support obligation) for assuming this debt or a larger percentage. However, since separate households exist or are envisioned, any computation in the Bankruptcy can take this factor into consideration.

Close work between all counsel – in the divorce and in the Bankruptcy – is recommended. While this may not be the first option, it may be better than simply allocating the debts and assets, entering Judgment, and hoping for the best.

As a general overview, a Chapter 13 is filed under the following situations:

1. **Chapter 7 not available or feasible.** This can be where the person earns too much money and is unable to rebut the presumption of abuse or has too much non-exempt assets. It can also be where the desired benefits of a BK7 are not realized.
2. **The desire for a reinstated mortgage.** A Plan can be crafted to save a house and avoid (or end) a Foreclosure. The existing and required mortgage payment is resumed with the arrears are paid over the course of the Plan. All creditors, including the Mortgage Company, are bound by the Plan. Foreclosure and displacement of the homeowner are immediately stayed and, hopefully, avoided by completion of the Plan.
3. **The potential debtor(s) is over-leveraged or appear to be asset-rich/cash poor.** An example would be a vehicle. Should the debt exceed the value, a restructuring of the debt total and/or the interest rate may be an option. The interest rate can be reset with the debt

set equivalent to its value. This may result in great savings to a Debtor. Similarly, if the vehicle has a value over the available exemptions coupled with any lien, a Plan can be crafted to make the required payments, but avoid any need to turn-over the vehicle as would be the result in a BK7.