Banks Must Use Caution When Reporting Bankrupt Customers To Credit Agencies

Banks and other financial institutions regularly submit information to credit reporting agencies to enable each other to evaluate borrowers' creditworthiness. Indeed, most do so routinely by providing computer tapes to credit reporting agencies. However, there may be a hidden risk to this seemingly innocent practice—liability for violation of the Bankruptcy Code's automatic stay.

In its most general sense, the automatic stay prohibits creditors from attempting to collect on a pre-petition debt after the debtor files for bankruptcy relief. In other respects, however, the automatic stay can be a trap for the unwary. Courts have found that merely making a telephone call or sending a letter demanding payment can violate the automatic stay, and may impose harsh penalties, including holding the violator in contempt of court, awarding legal fees and costs, or imposing punitive damages.

But what if a bank—as a customary part of its business—merely provides negative information about a bankrupt debtor or the non-filing spouse of a bankrupt debtor to a credit reporting agency? While the report may be accurate and serve a legitimate business purpose, it may nonetheless be a violation of the automatic stay.

> "...a creditor may not act, or commence or continue any civil action to collect all or any part of a consumer debt...unless the debt was a business debt or the chapter 13 was closed.

The problem most often arises when a married debtor has filed a chapter 13 bankruptcy and the debtor's spouse has not joined in the petition. Section 1301 of the Bankruptcy Code stays actions against co-debtors and (with certain exceptions) prevents creditors from taking actions against not only the debtor but also the non-filing co-obligor spouse (or any other joint obligor). In particular, the statute provides that after the

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- The bankruptcy court may, at the request of a creditor, modify the terms of a debtor's plan to reflect increases or decreases in the debtor's income.
- The property distributed under the debtor's plan must meet the "minimum repayment plan threshold," *i.e.*, payment received by the creditor under the plan must be greater than or equal to the amount of the creditor's claim, or greater than or equal to the creditor's *pro rata* share of the debtor's disposable income during the five years following the date of the first payment.
- The bankruptcy court may not discharge the debts of an individual until all payments under the plan have been completed unless the value actually distributed is equal to or greater than what the creditors would have received under a chapter 7 liquidation.
- The debtor may only invoke the homestead exemption, *i.e.*, the protection afforded to the debtor's equity interest in his or her home, if the debtor resided in the state where the home is located for 730 days prior to filing for bankruptcy protection.
- Regardless of the level of state homestead exemptions, the debtor may only exempt up to $125,000 of interest in a home that was acquired within the 1,215-day period prior to the filing.
- To the extent the home was obtained through fraudulent conversion of nonexempt assets during the 10-year period before the filing, the exemption is reduced by the amount attributed to the fraud.
- Individual retirement plans of the debtor are capped at $1,000,000.

The BAPCPA significantly reduces the ability of high income debtors to receive a "fresh start," one of the fundamental purposes of the Bankruptcy Code. Under the pre-BAPCPA Bankruptcy Code, debtors could simply convert non-exempt assets, like cash and investments, into exempt assets, like residential real estate and retirement accounts, and file a bankruptcy petition under chapter 7 of the Bankruptcy Code. All of the equity in the home and the retirement accounts were protected and the debtor's post-petition income was unavailable to satisfy claims of pre-petition creditors. This type of "bankruptcy planning" was permitted even when the debtor freely admitted that the sole purpose was to protect assets from creditors.

Under the BAPCPA, however, the homestead exemption is significantly restricted and retirement accounts are capped. Equally as important, the debtor's post-petition income must be reported and used to pay the debtor's pre-petition obligations. In most cases, this will lead to high income debtors paying off all, or nearly all, of their debts just as they would have been required to do without the provisions of the Bankruptcy Code.

Unless, as Senator Jon Corzine (D-NJ) suspected, millionaires can find "smart lawyers" to find loopholes in the BAPCPA, voluntary filings by high income debtors may become a thing of the past. Of course, what is bad for debtors is often good for lenders and other creditors. Involuntary chapter 11 filings may be a relatively easy means of initiating and assuring a debtor's repayment of its obligations. With this in mind, creditors should carefully monitor their high income borrowers and consider an involuntary chapter 11 bankruptcy case as a remedy of first resort, rather than last.

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to heed the advice of its search firm to check the name used by IRS.

The court rejected for policy reasons the suggestion that the IRS should be held to the same filing standards as Article 9 creditors, concluding that it would "unduly burdensome to the government's tax collection efforts." While it might be unduly burdensome to the IRS, a lender's ability to conduct due diligence and protect itself also got significantly harder.

RECOMMENDATIONS AND PRACTICE TIPS

So what recommendations do we have for lenders to ensure that they are protected?

- *Conduct a "preliminary name variation search"* in all states where the debtor does business, resides or owns property. This can alert you to any name variations which might, on further inquiry, prove to be your borrower.
- *Require early delivery of all recent tax returns.* In almost all cases, the IRS will file against the taxpayer using the name employed on its returns. You should get a copy of those returns early on in the due diligence and conduct searches using any name or names which appear there. Note though that the Federal Tax Lien Act provides that tax lien notices be filed in the state where the taxpayer "resides" and that the "residence" is deemed to be where it has its "principal executive office." So if your borrower is a Delaware LLC with its principal office in California, you must search with the California Secretary of State as well as the Delaware one.

We know that even with these steps, a search by the filing office using its own search logic might not uncover IRS liens. There is thus now an additional, and inherent risk of IRS lien priority but we believe that it can be substantially mitigated by the suggestions offered above.

Endnotes

1 26 USC §6323(f)(1)
2 UCC §9-502(a)(1)
3 UCC §9-503(a)(1)
4 26 USC §6323(f)(3)

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filing of a chapter 13 bankruptcy "a creditor may not act, or commence or continue any civil action, to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor, or that secured such debt" unless the debt was a business debt or the chapter 13 case is closed, dismissed or converted to a case under another chapter of the Bankruptcy Code. 11 U.S.C. §1301.

If a bank submits a negative report about a chapter 13 debtor's non-filing spouse and the spouse then is unable to obtain credit, the non-filing spouse may argue that the bank made the negative report in an attempt to coerce either the non-filing spouse or the filing spouse (through intimidation of the non-filing spouse) to pay the debt. It may sound far-fetched, but at least two bankruptcy courts have held under these very facts that the reporting bank violated either the automatic stay of Section 362 or the co-debtor stay of Section 1301 of the Bankruptcy Code. In each case, the bankruptcy court rejected the bank's argument that the debtor and/or the co-debtor suffered no damages by the reporting. *See In re Sommersdorf*, 139 B.R. 700 (Bankr. S.D. Ohio 1992); *In re Singley,* 233 B.R. 170 (Bankr. S.D. Ga. 1999). That the court considered the providing of the credit report to also be a violation of the automatic stay of Section 362 of the Bankruptcy Code is troubling. The co-debtor stay of Section 1301 relates only to consumer debts, but the automatic stay of Section 362 has no such limitation and applies to both consumer and business debt.

As is often the case in bankruptcy, there is contrary authority. At least one district court has concluded that truthful reporting to credit agencies concerning a bankrupt debtor does not violate the automatic stay. *See Hickson v. Home Federal of Atlanta*, 805 F. Supp. 1567 (N.D. Ga. 1992).

Unfortunately, the issue has yet to be squarely addressed by a federal court of appeal. Moreover, because the issue of intent appears to be critical, if the debtor or non-filing spouse can credibly argue that the reporting lender was acting with the intent to collect a debt, a stay violation may be found. One possible solution is to simply not make reports to credit agencies regarding the accounts of bankrupt debtors and their spouses; there is logic to such an approach, given that the bankruptcy will also be part of the credit agency files. Another option is to continue the reporting but to immediately delete the notation upon request of the borrower. Either way, it is always wise to proceed with caution in any matter relating to credit reporting or collection when bankruptcy is involved.

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