BANKRUPTCY PITFALLS AND PRACTICE TIPS

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About one million individuals and businesses file for bankruptcy every year in the United States. By doing so, these individuals and businesses receive considerable relief under the Bankruptcy Code, and are often able to discharge or reorganize their debts to emerge with a "fresh start." While bankruptcy is generally a tremendous boon to debtors, provisions in the Bankruptcy Code allow the U.S. Bankruptcy Court jurisdiction over virtually all of the debtor's assets and liabilities, and allow the court to review and avoid transactions made by the debtor up to ten years before the filing date.

As a result, lawyers of all specialties who can spot bankruptcy-related issues can provide tremendous value for their clients. This article explores some ways in which they can do this.

The Court May Avoid Payments to Creditors and Avoid Properly Perfected Liens Up to One Year Prior to the Petition Date as a Preference

A preference claim arises when a debtor transfers money or an interest of the debtor in property to a creditor within the preference period. The preference period is ninety days from the petition date for non-insider creditors, and one year for insiders. 11 U.S.C. § 547(b). Avoidable preferences often include judgment liens recorded against the debtor's property or payments made by the debtor to trade creditors within the preference period. The Bankruptcy Code allows a debtor to recover these preferential transfers from the creditor by filing a lawsuit against them.

To establish that a defendant received a preferential transfer under Section 547 of the Bankruptcy Code, the debtor must prove the elements of 11 U.S.C. § 547(b). These elements include that payments were received by a creditor on account of a pre-existing debt, and that the preferential payments were made (i) while the debtor was insolvent, (ii) within ninety days before the debtor filed for bankruptcy, and (iii) the payments provided the creditor with more payments than it would receive if the debtor had liquidated under a chapter 7 liquidation. 11 U.S.C. § 547(b).

Each element must be proved by a preponderance of the evidence, although there is a presumption of insolvency in the ninety days before the bankruptcy filing. 11 U.S.C. § 547(f). Both creditors and debtors should be aware that the Bankruptcy Code offers certain defenses to the creditor through which the preference payment does not have to be returned. The three most common defenses are: (1) a payment made in the ordinary course of business; (2) a payment paid for subsequent new value; and (3) a payment that was a contemporaneous exchange for new value given to the debtor. 11 U.S.C. § 547(c).

In the context of litigation, a frequent misstep we see in practice is non-bankruptcy counsel delaying the involvement of bankruptcy counsel until after a judgment has been recorded against the debtor's assets and after the ninety-day preference period has run. While a judgment recorded against the debtor's assets during the preference period is avoidable (and will be treated as an unsecured claim in bankruptcy), often nothing can be done after the preference period has run to free up these assets for the debtor's reorganization. Accordingly, we recommend that non-bankruptcy counsel involve bankruptcy counsel in all stages of high-stakes litigation.

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The Bankruptcy Court May Void Transactions Made Within Ten Years of the Petition Date as a Fraudulent Conveyance

A fraudulent conveyance is any transfer of property or obligation from the debtor made within four years of the filing date, for which the debtor either intended to hide assets from creditors, or was insolvent and did not obtain "reasonably equivalent value."

Even innocent good-faith purchasers of property may lose the benefit of their purchase if a debtor sells them property for an amount that the Bankruptcy court later determines was less than fair market value. A good-faith purchaser can suffer even though it had no knowledge that the transfer was fraudulent or that the purchase price was less than fair market value. *In re Maddalena*, 176 B.R. 551, 558 (Bankr. C.D. Cal. 1995). Once the Bankruptcy court makes a determination that a transfer was fraudulent, the debtor or trustee may recover and sell the

property for the benefit of creditors.

Attorneys advising clients who are planning to file for bankruptcy, or foresee that bankruptcy is a strong possibility, are advised to structure their transactions to defend against claims that a transfer may be fraudulent.

In addition to avoiding fraudulent transfers made within four years of the filing date, Section 548(e) of the Bankruptcy Code provides for an extraordinary ten-year clawback period in the case of fraudulent transfers to self-settled trusts and similar device[s]." This statute is particularly far-reaching, as the term "self-settled trusts" has been interpreted to include trusts of which the settlor has "excessive control," (*In re Moses*, 167 F.3d 470 (9th Cir. 1999)) and "similar device[s]" has been interpreted so broadly as to include IRAs (*In re Thomas*, 477 B.R. 778 (Bankr. D. Idaho 2012)).

Counsel who are involved in asset planning are advised to regularly consult with bankruptcy counsel before structuring any trust that may end up in bankruptcy.

Bankruptcy as Litigation Defense

The mere filing of a bankruptcy petition creates an injunction known as the "automatic stay," which enjoins virtually all types of creditor activity and prevents the commencement or continuation of judicial, administrative, or other proceedings against the debtor, the debtor's assets, or the debtor's interests. The automatic stay applies to all creditors automatically without any action by the Bankruptcy court, and applies to creditors whether or not they have notice of the bankruptcy petition. The automatic stay has been described as the "cheapest injunction in town" and is a powerful tool to stay the enforcement of judgments, the commencement or continuation of litigation, the perfection of liens, the exercising of set-off rights, or any action to collect on prepetition debt. Interestingly, the debtor is not stayed from commencing or continuing litigation as a plaintiff. *In re Merrick*, 175 B.R. 333 (B.A.P. 9th Cir. 1994). The automatic stay generally remains in effect until the case is closed or the Bankruptcy court grants the creditor relief from the automatic stay.

The Bankruptcy court may grant creditors relief from the automatic stay for "cause," but courts typically allow debtors several months of protection before granting such relief. Even if the Bankruptcy court eventually grants a creditor relief from the automatic stay, the debtor has additional methods to delay litigation to focus on reorganization.

If the stay is lifted, the debtor's next step is often to file an application to remove the state court litigation to the Bankruptcy court, which is typically viewed as debtor-friendly. Upon the filing of the removal application, removal is effective and the creditor is enjoined from proceeding further in state court unless the Bankruptcy court orders a remand. Even if the Bankruptcy court remands the litigation back to state court, the debtor can often avoid the potential impact of litigation by having the Bankruptcy court estimate the plaintiff's claims or propose a plan of reorganization that pays the creditor pennies on the dollar. 11 U.S.C. § 502(c); 11 U.S.C. § 1123(b).

Creditors Should Request a Determination of Nondischargeability

While most debt is automatically discharged in bankruptcy, section 523 of the Bankruptcy Code sets forth various categories that are nondischargeable. These nondischargeable debts often require the creditor to obtain a determination of nondischargeability by filing an adversary proceeding within the debtor's case. However, it is often overlooked that before a debtor files for bankruptcy, a creditor may obtain a judgment from another state or federal court with findings that may be relied upon by the bankruptcy court to determine the nondischargeability of the debt. *In re Siragusa*, 27 F.3d 406, 408 (9th Cir. 1994) ("[T]he divorce court had jurisdiction to determine that the payments to [the debtor's ex-wife] were in the nature of alimony, and therefore not dischargeable under § 523(a)(5)").

Creditors considering litigation against a debtor who may file bankruptcy should try to obtain findings on the issue of nondischargeable claims in the court where they seek relief, as such issues previously adjudicated may be relied upon by the Bankruptcy court and will be subject to collateral estoppel. *In re Bugna*, 137 B.R. 785 (Bankr. C.D. Cal. 1992) ("State court's findings that debtor committed actual fraud while acting in fiduciary capacity could be given collateral estoppel effect in determining whether state court judgment debt was nondischargeable"), *subsequently aff'd*, 33 F.3d 1054 (9th Cir. 1994).

Filing a Proof of Claim Forfeits the Right to a Jury Trial

Congress enacted legislation in 1994 specifically authorizing Bankruptcy courts to conduct jury trials. However, jury trials in Bankruptcy court are exceedingly uncommon. By filing a proof of claim, a creditor is invoking the equitable jurisdiction of the Bankruptcy court and irrevocably forfeits its right to a jury trial. *In re EXDS, Inc.*, 301 B.R. 436 (Bankr. D. Del. 2003). Creditors that place particular value on their right to a jury trial should consider relying on the scheduled amount of a claim.

Bankruptcy Does Not Automatically Terminate Contracts

Merely filing for bankruptcy does not automatically terminate an agreement, even if the agreement specifically states that the contract is terminated if either party files for bankruptcy. These clauses are known as *ipso facto* clauses, and they are unenforceable in bankruptcy. 11 U.S.C. § 365(e)(1). If enforcing an *ipso facto* clause is an important provision in your client's agreements, we recommend consulting with bankruptcy counsel to revise these contracts so they can be terminated a different way.

Discharging Tax Liabilities

Most state and federal tax liabilities are dischargeable in bankruptcy, and while there are technical rules requiring strict compliance, proper planning in anticipation of bankruptcy can often allow for a complete discharge of these liabilities. For example, unsecured income tax liabilities may generally be discharged if: (1) the taxes were due more than three years prior to the bankruptcy petition; (2) a tax return was filed more than two years prior to the bankruptcy petition; and (3) the taxes were assessed more than 240 days prior to the filing of the bankruptcy petition.

Conversely, certain tax liabilities (such as unpaid payroll taxes or sales taxes) are never dischargeable in bankruptcy. Accordingly, counsel who anticipate that their client may need to file for bankruptcy should consider consulting a bankruptcy attorney to ensure the dischargeability of their client's tax liabilities.

Conclusion

Like other niche areas of the law, bankruptcy can be an opportunity for those who understand its advantages and opportunities, and can be a minefield for those who do not.

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