# Bankruptcy and Creditors' Rights

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## Up for discussion:

- Basics of bankruptcy
- Exceptions to discharge
- Defending against preferential transfer actions

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# Bankruptcy 101

- Brief overview of the key players
- The different types of relief
- Overview of automatic stay

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Bankruptcy 101

# Key players

- Debtor
  - Individual, corporation, or debtor-in-possession
- Trustees
  - US Trustee (oversees a region)
  - Case trustee (appointed in ch. 7)
  - Standing trustee (chs. 12 and 13)
  - Chapter 11 (rare-only involves fraud, dishonesty, incompetence, or gross mismanagement ...otherwise, DIP)

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## Key players (continued)

- Committees
  - Unsecured creditors in ch. 11
  - Other types:
    - Equity
    - Retirees
    - Bondholders
- Secured creditors
- Professionals
  - Attorneys
  - Accountants
  - Investment bankers

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## Various Types of Bankruptcy

- Chapter 7
  - Complete liquidation
  - Individual or company
- Chapter 11
  - Reorganization
  - Individual* or company
- Chapter 13
  - Individual reorganization
  - Wage earner

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## Chapter 7

- Orderly, court-supervised procedure
- Automatic stay
- Trustee theoretically takes over assets of debtor's estate and can sell it all
- In reality, this almost never happens – debtor's assets are either worthless or exempt

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## Chapter 11

- Voluntary or involuntary
- Automatic stay
- Existing management stays in control (usually)
- DIP has special powers:
  - Reject executory contracts and leases
  - Avoid certain transfers of property
- Disclosure statement and plan of reorganization
- Confirmed plan grants a discharge of prepetition and postpetition debts (prior to confirmation of plan)

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## Chapter 13

- Debtor must have regular income
- Debtors prefer this chapter if they want to keep a valuable asset, such as a home
- Debtor has three to five years to repay creditors
- Debtor might be forced into Chapter 13 (means test)
- Automatic stay in effect for duration of plan
- Debt raised from dead if debtor fails plan

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## Automatic Stay

- Section 362 of U.S. Bankruptcy Code
- Most important and powerful tool available to debtor
- Effective immediately upon filing
- Bars almost all attempts to collect money from debtor

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## Automatic Stay

- Purpose:
  - Protects debtor AND creditors (avoids a run on the courthouse)
- Effect:
  - Stops ALL collection activities
  - This includes withholding garnishments

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## Automatic Stay

- Exceptions
  - Criminal actions (of debtor)
  - Child custody/support/paternity obligations
  - Divorce proceedings (division of property actions not included in this exception)
- May be lifted upon successful motion of creditor

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## Discharge of Debt

- Debtor must sometimes survive challenges to discharge, i.e. bad faith bankruptcy filing, fraud, etc.
- If debt is discharged, that occurs:
  - Chapter 7 – 60-90 days after 341 meeting
  - Chapter 11 – upon confirmed plan of reorganization
  - Chapter 13 – when debtor completes plan

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## Exceptions to Discharge Under Bankruptcy Code Section 523

Preventing a bankrupt party from discharging its debt to you.

*"Not so fast, my friend, not so fast."*
*- Lee Corso*

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# Overview of Section 523

- *Individual debtors who successfully navigate the bankruptcy process receive a "discharge" of their debts. This means they are no longer legally liable for the debts.*
- *However, not all debts are dischargeable. Section 523 of the Bankruptcy Code provides several exceptions to the general rule that debts are discharged through bankruptcy.*
- *Often, your client's first analysis (when faced with notice that one of its debtors has filed bankruptcy) will be to determine whether chasing the debtor through the bankruptcy process is worth the effort.*

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# Exception to discharge actions

**(who - what - when - where - why)**

- *Creditor initiates action*
- *Commenced by filing a complaint in an adversary proceeding within bankruptcy case*
- *Must be filed within sixty (60) days of the 341 meeting of creditors (court will typically set a deadline by which objections to discharge must be filed)*

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# Most Common Exceptions to Discharge Provided Under Section 523

- ***No discharge for debt related to money, property, services, or an extension, renewal, or refinancing of credit, to the extent debt was obtained by***
  - ***False pretenses, false representation, or actual fraud***
    - *11 U.S.C. § 523(a)(2)(A)*
  - ***False written statement respecting debtor's financial condition***
    - *11 U.S.C. § 523(a)(2)(B)*
  - ***Fraud or defalcation while acting in a fiduciary capacity***
    - *11 U.S.C. § 523(a)(4)*
  - ***Willful and malicious injury by the debtor***
    - *11 U.S.C. § 523(a)(6)*

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# False pretenses, false representation, or actual fraud

- *In order to use this section to prevent a debtor from receiving a discharge, the plaintiff/creditor must establish five elements:*
  i. *debtor made a material false representation*
  ii. *debtor knew of falsity*
  iii. *debtor intended to deceive creditor*
  iv. *creditor relied on misrepresentation*
  v. *creditor was damaged*

- *To prevent a debtor from receiving a discharge under (a)(2)(A), the creditor must show that the debtor intentionally defrauded the creditor. However, some courts have held that "intent to deceive can be inferred from surrounding circumstances."[1]*

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## False pretenses, false representation, or actual fraud

- “False representation” is different from “false pretense”[1]
  - False representation = express misrepresentation
  - False pretense = implied misrepresentation or conduct intended to create and foster a false impression
- False pretenses ≠ overt misrepresentations[2]
  - Omissions & failure to disclose can constitute misrepresentations where they create a false impression

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## False written statement respecting debtor’s financial condition

- *In order to use this section to prevent a debtor from receiving a discharge, the plaintiff/creditor must establish five elements:*
  - *i. statement is in writing*
  - *ii. is materially false*
  - *iii. respecting debtor’s financial condition*
  - *iv. creditor reasonably relied on statement*
  - *v. debtor created or issued statement with intent to deceive creditor*
- *Includes debts arising from renewal or extension of credit as well as forbearances*
- *Creditor does not have to prove that statement was the only factor / partial reliance ok*
- *To determine intent to deceive, court looks at totality of circumstances, including recklessness of debtor’s actions*
- *Intent can be inferred*

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# Fraud or defalcation by a fiduciary

- *To deny discharge, the fiduciary relationship must rest on a technical or express trust and not upon a trust implied in law from an act of wrongdoing.*[1]
- *Ordinary commercial relationships (principal/agent, debtor/creditor, etc.) are generally not considered fiduciary*
- *The fiduciary relationship must exist before incident creating the debt and apart from it. "It is not enough that the trust relationship spring from the act from which the debt arose."*[2]
- *Corporate officers who have filed bankruptcy have been denied a discharge when the debt in question arose from the debtors' misuse of their positions to gain a personal benefit at the expense of the corporation or corporate creditors.*[3]

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# Willful and malicious injury

- *Section 523(a)(6) denies dischargeability to debts "for willful and malicious injury by the debtor to another entity or to the property of another entity."*
- *Willful and malicious injuries are those resulting from acts, such as intentional torts, that are carried out with an actual intent to cause injury as opposed to acts done intentionally that result in injury.*[1]
- *Examples include assault and battery, damages for libel if statements made knowingly, medical malpractice (but not if malpractice due to mere negligence or lack of skill).*
- *Conversion is an often overlooked basis for nondischargeability under (a)(6):*
    - *Ford Motor Credit Co. v. Owens, 807 F.2d 1556 (11th Cir. 1987) – Court of Appeals held that the sale of cars by dealership, in which debtor was the majority stockholder and president, was willful and malicious conversion of creditor's property; debtor was personally liable for dealership's actions where debtor made decision to dispose of cars and not turn proceeds over to creditor.*

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# Special considerations for fiduciaries under "Fraud or defalcation of a fiduciary"

- *The holding of Bullock v. BankChampaign, N.A., 133 S. Ct. 1754 (May 13, 2013) is worth considering for those of you who have clients serving in a fiduciary capacity.*
- *The central issue before the Court in Bullock was whether "defalcation in a fiduciary capacity" encompasses any failure to satisfy a fiduciary duty, regardless of intent (a low threshold), a knowing breach of fiduciary duty (a higher threshold), or an even higher standard.*
- *The Supreme Court found that a higher standard applies.*

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# Special considerations for fiduciaries under Section 523(a)(4) "Fraud or defalcation of a fiduciary" (Analysis of Bullock continued)

- *The petitioner in Bullock was the trustee of his father's trust, which had been established for the benefit of the father's five children (including petitioner). The petitioner borrowed money on three occasions from the trust; once to repay a debt to the father's business, once to pay for certificates of deposit that petitioner and his mother used to buy a mill, and once to buy real property for petitioner and his mother. All of the loans were repaid to the trust, along with 6% interest.*
- *Petitioner's brothers sued, claiming a breach of fiduciary duty. The state court ruled that although petitioner "did not appear to have had a malicious motive in borrowing funds from the trust," he was "clearly involved in self-dealing."*

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## Special considerations for fiduciaries under Section 523(a)(4) "Fraud or defalcation of a fiduciary" (Analysis of Bullock continued)

- *After the petitioner tried unsuccessfully to liquidate his interests in the mill and other assets to make the court-ordered payment, he filed for bankruptcy protection.*

- *BankChampaign opposed petitioner's efforts to discharge the debt embodied by the state court judgment. Judge Caddell granted BankChampaign's motion for summary judgment, ruling that the debt fell within 523(a)(4)'s exception "as a debt for defalcation while acting in a fiduciary capacity" and was therefore nondischargeable. Judge Caddell's holding was affirmed by the district court and the Eleventh Circuit.*

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## Special considerations for fiduciaries under Section 523(a)(4) "Fraud or defalcation of a fiduciary" (Analysis of Bullock continued)

- *The Supreme Court reversed the Eleventh Circuit.*

- *In so doing, the Court held that "where the conduct at issue does not involve bad faith, moral turpitude, or other immoral conduct, the term [defalcation] requires an intentional wrong." The Court further held that defalcation "includes a culpable state of mind … one involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior."*

- *"We believe that the statutory term 'defalcation' should be treated similarly" to the Court's interpretation of the term "fraud" in the 1878 decision of <u>Neal v. Clark</u>.*

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## Denial of discharge under Section 727

- *If debtor does any of the following, and the trustee discovers it, the debtor does not get a discharge of ANY debts:*
  - *Lying on schedules*
  - *Hiding assets*
  - *Failing to maintain accurate financial records*
  - *Creating false records*
  - *Refusing to turn over records*
  - *Refusing to cooperate with trustee*

- *In a 2005 article in GPSolo magazine, the ABA described a 727 denial of discharge "bankruptcy hell": debtor loses non-exempt property for payment of creditor claims, but does not get a discharge of remaining debts.*

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# Preference Actions Under Bankruptcy Code Section 547

What to do when a bankruptcy trustee demands that your client return payments to a bankrupt company.

*"The big print giveth, and the fine print taketh away."*
*-Tom Waits*

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## Typical Scenario:

*Your client calls you in a state of panic, confusion, anger, or disbelief. They have just received a letter from a trustee or a debtor-in-possession demanding the recapture, or "repayment," of money your client received from a company that is now in bankruptcy.*

*Eventually, the trustee sues your client to recover the allegedly "preferential" transfer.*

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## Typical Scenario:

*Your client exclaims: "This is not fair! We sent them valuable merchandise, they paid us for it … end of story. Now we have to give them their money back?!"*

*Fair or not, sometimes that is precisely what happens.*

*However, there are several exceptions to this general rule that could provide a creditor with one or more valuable defenses to the trustee's preference action.*

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## Overview of Section 547

*The underlying purpose of preference law is the desire to insure an equal distribution of available assets to all creditors. Think "Humpty Dumpty" – one of the trustee's duties is to put the debtor back together again, like he was 90 days before filing bankruptcy.*

*That way, the trustee (not the creditors or the debtor) can determine who gets what.*

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## Overview of Section 547

*The plaintiff has the burden of proving that the pre-petition transfer is avoidable because it constitutes a preferential transfer under section 547(b) of the Code.*

*Thereafter, the burden of proof shifts to the defendant, against whom recovery or avoidance is sought, to prove that it is entitled to one of the affirmative defenses to preferential transfers as set forth in section 547(c) of the Code.*

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# Elements of a preferential transfer

*A preference is a transfer of an interest of the debtor in property:*

- *Made to or for the benefit of a creditor*
- *On account of an antecedent debt*
- *While debtor was insolvent*
- *Made within 90* days prior to petition filing date*
- *That provides creditor with more than it would have received in a chapter 7 liquidation*

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# Preferential transfers in plain English

*If successful in bringing a preference claim, the debtor or trustee is able to "avoid," or cancel, a transaction (almost always the payment of money) that occurred just before the bankruptcy was filed.*

*Prevents some creditors (who received the preferential transfer) from gaining an unfair advantage over similarly situated creditors who won't be paid in full.*

*Typically only available to unsecured creditors - payments to fully secured creditors do not result in that creditor receiving more than it would in a chapter 7*

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# Preferential Transfer actions

**(who - what - when - where - why)**

- *Debtor or trustee must initiate preferential transfer action*
- *Commenced by filing a complaint in an adversary proceeding within bankruptcy case*
- *Must be filed within two years of the date debtor filed bankruptcy*

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# Defenses available under 547(c)

*There are defenses available to your client that might allow them to retain the money the trustee is demanding.*

*These defenses are found in the exceptions provided in Section 547(c).*

*Today we will examine the most common defenses:*

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## Defenses available under 547(c)

- ***Contemporaneous Exchange of New Value***
  - *11 U.S.C. § 547(c)(1)*
- ***Ordinary Course***
  - *11 U.S.C. § 547(c)(2)*
- ***Subsequent New Value***
  - *11 U.S.C. § 547(c)(4)*

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### Contemporaneous Exchange for New Value

*An otherwise preferential transfer is protected by this defense when:*

*(1) the transferee extends new value to the debtor in exchange for the transfer*
*(2) the exchange was intended by the parties to be contemporaneous, and*
*(3) the exchange was in fact substantially contemporaneous.*

*The purpose of the contemporaneous exchange exception is to protect transactions that do not result in the diminution of the bankruptcy estate.*

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## Contemporaneous Exchange for New Value

*The critical issue for most courts is whether the parties intended the exchange to be contemporaneous.*

- *What if payment occurs several hours later?*
- *Does payment by personal check count as contemporaneous?*

*"New value" can be money, goods, services, or new credit.*

*New value does NOT include discharge of one unsecured debt in return for a second, secured debt, nor does it include forbearance in exercise of remedies.*

*Code does not explicitly require that the exchanged property be of equivalent value (but court could view exchange to be preferential to the extent debtor benefits)*

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## Ordinary Course

*An otherwise preferential transfer is protected by this defense when:*

*(1) the transferee extends new value to the debtor in exchange for the transfer*
*(2) the exchange was intended by the parties to be contemporaneous, and*
*(3) the exchange was in fact substantially contemporaneous.*

- *Intention is to validate ordinary credit transactions.*
- *Might not be available to creditors who have altered credit terms.*

- *Two standards must be met:*
  - *Debt must have been incurred in ordinary course of debtor's and creditor's business, AND*
  - *Payment or transfer must be made:*
    - *1. In the ordinary course of business between debtor and creditor* ***OR***
    - *2. According to ordinary industry terms of the parties*

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## Ordinary Course

- *Courts will also look for the following, any of which might prevent the creditor from successfully asserting the "ordinary course" defense:*
  - *A change in payment terms*
  - *A change in the timing of payments*
    - *Range of payment periods*
    - *Average of payment periods*
  - *Size of invoices compared with size of payments*
    - *Credit limit exception*
  - *Whether the creditor engaged in unusual or coercive collection tactics*
    - *Can you call the debtor?*
    - *Can you send collection letters to debtor?*

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## Subsequent new value

- *Under this defense, a transfer is not avoidable if creditor gave new, unsecured value to debtor after the alleged preferential payment.*
- *It is almost as if the court is saying "okay, there was a preferential transfer to creditor, but creditor 'repaid' it by subsequently giving value to debtor."*
- *The subsequent value given by creditor returns the estate to its pre-preference state, thereby restoring the previous depletion.*
- *So, if a creditor supplies services or ships new goods on an unsecured basis after the transfer, the value of those goods or services is ordinarily subtracted from the original preference amount because the bankruptcy estate has been replenished.*
- *Most often seen in context of revolving credit relationships.*

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# Conclusion

- *All is not lost just because a bankruptcy trustee comes knocking on your client's door.*
- *Secured creditors generally don't have to worry about preference liability – payments to fully secured creditors do not result in that creditor receiving more than it would in a chapter 7*
- *A company that deals with a financially distressed counterparty (i.e. supplier) should contact legal counsel as soon as the counterparty's financial distress becomes apparent.*
- *Your client should make sure it does not alter the terms or course of dealings with the counterparty, especially before speaking with counsel.*
- *While maintaining proper financial records might not be enough to "win the day," failing to do so puts a company at a severe disadvantage in a preference action when fighting to retain payments it has received.*

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# Questions?


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