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Consumer Workshop III

Cleaning It Up: Messy Chapter 7s

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MESSY BANKRUPTCIES
OUT OF THE FIRE AND INTO THE BANKRUPTCY:
Potential landmines and how to avoid them

Presenters: Jessica Deal and Stephen Berken

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What do Bram Stoker, Edgar Allen Poe, Stephen King and the inattentive debtor's counsel have in common?

Each can tell a great horror story.

Horror Story Number One

Debt Cemetery

- Debtor is the captain of a sinking ship (i.e., business). He personally guaranteed corporate leases, all in default. He closes the business.
- He puts his half a million-dollar unencumbered house into a trust. Trade creditors sue the defunct business and Debtor. Trade creditors do not raise fraudulently conveyance claim in state court.
- Two years after creating the Trust, Debtor files chapter 7.
- Trustee sues trust under fraudulent conveyance theory. Debtor loses the house.
- In situations like this, it is better to forget a bankruptcy and defend the lawsuits directly. Try to reach settlement agreements with the creditors while debtor has control of his property.

The Strange Case of Dr. Jekyll and Dr. Tan Your Hide

- Debtor is supported by wife. Has no assets. Resides in a house titled in wife's name.
- Debtor owes a substantial amount of debt from failed business. Two years prior, he and wife transferred assets into a trust for benefit of child.
- **No pending litigation from creditors. No claims of fraudulent conveyance in state court.**
- Debtor files Chapter 7. (What?!) Trustee brings fraudulent conveyance claim against non-filing spouse.
- Wife files Chapter 11. \$2M of claims filed. Wife has substantial non-exempt assets. Converts to Chapter 7. Trustee begins liquidation of non-exempt assets.

The Island of Dr. Moron

- Debtor contacts counsel one day before foreclosure sale, prompting quick Chapter 13 filing.
- IRS files proof of claim – reflecting 4 years of unfiled returns
- Debtor files returns, owes \$60K in priority taxes
- Plan payments not feasible. Now what?
- Debtor’s counsel inquires of debtor— “if you haven’t been paying the mortgage for 12 months, or taxes for 4 years, where did the money go?”
- Debtor responds in the first in a series of blank expressions

Introduction: Due diligence

Extracting information from debtors is often arduous. As a group, not great record-keepers. Not particularly organized.

We know we are preaching to the choir. Counsel who might be best served with what we review are not here in this room. They do not attend these events. They are not seen in case law updates, bankruptcy CLEs, do not belong to NACBA or ABI.

Thus, we preach to the choir.

And this is the sermon.

The best thing you can do for your practice is remain a student of your craft.

Too many debtors’ counsel own one book. And it’s this one:

(Social Media Advertising for Dummies)***

Consider adding this book to your library:

(United States Bankruptcy Code)***

As we all know, bankruptcy is a lifesaver for many, but for some, bankruptcy can make a bad situation much worse.

I. How do we avoid landmine cases?

By its very nature, **Rule 9011** imposes a burden on debtor’s counsel. **The Court in re Withrow set forth the following five questions to determine whether this burden has been met:**

(1) **Education:** did the attorney impress upon the debtor the critical importance of accuracy in the preparation of documents and information submitted to the Court?;

- **A big part of our job is educating our clients about the bankruptcy process**
 - **Many non-lawyers and even lawyers that don’t practice in our field assume bankruptcy is a simple administrative task**

- **We must emphasize that A BANKRUPTCY is a FEDERAL CASE and the penalty of perjury is very high.**
- **Include this information during the consultation.**

(2) **Collect/review**: did the attorney seek from the debtor, **and then review**, whatever documents were within the debtor's possession, custody or control in order to verify the information provided by the debtor;

- Debtors counsel must go through our clients' documentation themselves.
- While office staff is helpful in the collection of the documents, the onus of reviewing the documents is on the attorney, in all cases, but especially complex cases.
- Attorneys have the trained eye and need to verify the information that substantiates the representations in the petition and schedule.
 - Example: Debtors counsel need to review bank statements before providing them to the Trustee. Discuss any questionable transfers and large purchases with client.

(3) **Reasonable inquiry**: did the attorney employ easily accessible verification tools? (e.g., online real estate title compilations, on-line lien search, tax transcripts);

- Many debtors are not financially savvy and/or may have gaps in their memory
- In all cases, but especially in cases where debtors have had a complex financial history, debtors counsel should cover all bases and conduct research:
 - O/E report
 - Clerk and recorder judgement search
 - Zillow (property history—verify sale history and purchase price)
 - Zaba – real estate history

(4) **Accurate filings**: was any of the information provided by the debtor and then set forth in the debtor's court filings internally inconsistent—that is, was there anything which should have obvious to the attorney that the information provided by the debtor could not be accurate;

- Did debtor's counsel knowingly omit information or construe information?
- Did debtor's counsel miss an obvious and unfavorable inconsistency?
 - Example: An easy miss – Debtor tells his attorney he is not married and never been married. Debtor's attorney's paralegal collects all docs including tax returns. Debtor's case is filed, and tax returns are sent to the Trustee. Trustee asks debtor at 341 why his tax returns list a spouse. "Oh, my accountant said I was not legally married, but common law married, which doesn't count." Cue the can of worms.

(5) **Quick to correct:** did the attorney act promptly to correct any information presented to the Court which turned out notwithstanding the attorney's best efforts, to be inaccurate.

- Mistakes are going to happen. The key is, if you discover an inconsistency or omission in the petition or schedules, promptly file an amendment and notice of that amendment
- Email or call the Trustee and/or opposing counsel to inform them of the error and your plan to rectify it.

II. Due diligence/Ask the hard questions/Checklist:

Initial Client Contact:

1. **Pending litigation?** Review the pleadings. Are you trading one forum (state court) for another (bankruptcy court)? Is fraud alleged in state court? Discharge may be barred under 11 U.S.C. §523 (a)4.

(*In re Seare*, 493 B.R. 158 (2013)) State court litigation finds fraud by debtor. Attorney assumes it's a big medical debt. Hospital files § 523 action. Debtor's counsel declines to defend. BK judge determines counsel failed to advise client of non-dischargeability and orders disgorgement).

2. **Dissipation of assets:** can debtor explain?

- Theft: is there a police report? Is the stolen property encumbered?
- If sold, were assets sold to an insider? Were assets sold for fair market value?
- **Prior bankruptcy filings?** Dismissed chapter 13? Serial filer? Changed circumstances? Re there unrealistic expectations?

3. **Prior cases/potential issues:** difficult

- Debtor says, "My other three attorneys were terrible, but I think you and I will get along great!"
- If there was a prior case pending in the last 12 months, can the automatic stay be extended pursuant to 11 U.S.C. §362 (c)(3)? If there was a prior Chapter 13 and the debtor wishes to file a subsequent Chapter 13, has there been a change in circumstances? If not, probably bad faith / multiple filings.

4. **Potential inheritances and life insurance proceeds.**

- There is no delicate way of asking whether somebody's nana is going toward the light, but best to have those awkward conversations during the consultation, rather than getting the death announcement. Of these questions, consider asking:
 - i. Any terminal illnesses?
 - ii. Have you lost anyone in the last few years?
 - iii. Non-filing spouse? How is their health?

- If Debtor becomes entitled to an inheritance or life insurance proceeds within (180 days) or 6 months, it is an asset of the estate (11 U.S.C. 541 (a)(5)(A))
 - i. But maybe not via an inter vivos trust?
- In Chapter 13, trustee will argue disposable income.
- IRAs that are funded by inherited funds are not exempt.

5. Talk about the consequences of not being honest.

- “Do I have to list everything?”
- “You’ve been given a great gift, George.”
- Bankruptcies are Federal cases
- It is counsel’s responsibility to educate potential clients about the nature of bankruptcy and the consequences of perjury, which may include jail time.

6. Were there fraudulent transfers or repayments to an insider?

- Discuss all real estate owned and transfers made within the last 10 years.
 - i. Verify with a Zaba search and O&E report.
- Define transfer for them:
 - Were children added to the title of debtor’s homestead for estate planning purposes? Make sure they understand that the kids may have bare legal title.
 - Refinancing a home, and if a quit claim was part of the process? If there were proceeds, follow up with asking how the money was used? Did it go to paying off a friend or family member? (creating an avoidable preference)
 - If a sizable asset was sold, how were the proceeds spent? Rescuing relatives or friends?
- Was the transfer fraudulent?
 - Pursuant to 11 U.S.C. §548, a fraudulent transfer is made within two years of the petition date and
 - with actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted, or
 - received less than a reasonably equivalent value in exchange for such transfer or obligation or was rendered insolvent as a result.
 - Example: Father deeded homestead to son for less than fair market value of the property.
- Did they pay back a friend or family member for a loan?
 - Under 11 U.S.C. § 547(b), the Trustee may avoid any transfer of an interest of the debtor in property made (3) while the debtor was insolvent

(b) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider.

- Common example: Did the debtor repay a family member with their tax refund within a year prior to filing for bankruptcy?

7. Prior or pending divorce?

- Look at separation agreement to see whether it involves a simple division of assets and debts or if there is an actual domestic support order.
 - If the former, not dischargeable in Chapter 7. If the latter, arrears must be paid in the plan. Does that make a plan unfeasible?
- Are marital assets still in debtor's name?
 - Even if ex-spouse was awarded an asset (especially real estate) in the divorce, it is still property of the estate if it is still in the debtor's name.

8. Proceeds from the sale of a home during a Chapter 13:

- Can the Trustee force the debtor to agree in a modified plan that he/she will turn the proceeds over to the Chapter 13 Estate if the proceeds are not used to purchase another homestead within two years? The "snapshot" rule.

III. The trap of conversion

1. Conversions from 13 to 7 when the value of Debtor's homestead appreciated during the life of the Chapter 13 to the point of exceeding the exemption: Cue the § 348 litigation. Is post-confirmation, pre-conversion appreciation in value of the property subject to the Chapter 7 estate?

- a. 11 U.S.C. §348 (f)(1)(B): valuation of property and of allowed secured claims in the chapter 13 case shall apply only in a case converted to a case under chapter 11 or 12, but not in a case converted to a case under chapter 7.
- b. Conflicting authority:
 - i. *In re Hayes* (15-20727-MER) March 28, 2019
 - ii. *In re Barrera* (Adv. Pro. No. 18-1259-EEB) March 28, 2019.
- c. If exemptions increased during the life of the plan, Debtor is only entitled to exemptions in place as of the Chapter 13 petition date. The case law on that is old, and I believe that could very well be challenged, the question is at what cost to the Debtor.

IV. Trustees' perspective

1. *Pro se* debtors: Complete and truthful statements and schedules, turnover issues and general considerations.
2. Property of the estate issues in converted cases.
3. Post-discharge conversions. (If pondering a conversion from 7 to 13, file a motion to hold the order of discharge in abeyance.)
4. Calculating current monthly income in Chapter 13 (five-year versus three -year plan). *In re Gonzalez*, 18-10156 EEB.
5. Debtors on the move. Which exemption law applies when debtors move leading up to bankruptcy. *In re Willington*, 17-14318 EEB
6. Petition preparers—proper disclosure? Liability under Sections 526, 527 and 528.

V. Due diligence/How to protect yourself as debtors counsel:

1. Letter to client warning of possibilities. State court litigation could continue as an adversary case.
2. Tax waiver (if not wanting to hire a CPA to determine dischargeability).
3. Go through 341 questions prior to signing fee agreement. It ferrets out where problems are going to be.
4. Use a written questionnaire.
5. Does the person have enough dischargeable debt to make a bankruptcy worth it?
6. Expecting large tax refund?
 - Income tax refunds are property of a debtor's bankruptcy estate to the extent they are derived from withholdings from the pre-petition earnings of the debtor
 - Except for Earned Income Credit and *Additional* Child Care Credit, tax refunds are not exempt.
 - Non-exempt tax refunds are property of a debtor's bankruptcy estate to the extent they are derived from withholdings from the pre-petition earnings of the debtor
 - Conduct a cost-benefit analysis with the client: Is it worth waiting to file the case?
7. Prior business? Loss of assets? Where did the money go? Get forensic accounting BEFORE filing, not after.
8. Estimating Chapter 13 plan payments with caution.
 - In high-income, 100% plans, assume all creditors will file a POC—just in case. The older the debt, the less likely a POC will be filed. Creditors have “personalities.” www.annualcreditreport.com.

- If debtor has a large tax obligation, will debtor be able to pay it off in five years? Have all tax years been filed?
9. Do not believe client's estimations of value (home, car, artwork, Bernese Mountain dog, etc.)
 10. Check property records
 11. Check social media
 - Any boasting on Facebook, Instagram. (Is the budding Rambo holding a cache of firearms? Counsel can't "friend," but can see what is visible to the public.)
 12. Use your nose. Is the client going to be a nightmare to work with? Is the five-year relationship worth the brain cells? Is there difficulty with "the truth," does not return calls, respond to emails, addiction problems (gambling, drugs), "professional victim." Some potential clients will be a drain on your firm, even if their circumstances would make for a relatively straight-forward case. Yes, life is short. Will the client's chapter 13 case seem like an eternity?

REFERENCES:

SAMPLE QUESTIONNAIRE/CHECKLIST FOR TRUSTEES

1. Most of my/our debts are related to a business I operate or operated problems regarding: [Check all boxes that apply]

- taxes
- a lawsuit against me
- mostly credit card debt
- mostly medical debt
- mostly car or home loans
- a divorce/property settlement


2. Within the next 360 days, I expect my/our income to:


- increase
- decrease

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 remain the same

3. I/We have **RUSH CIRCUMSTANES** because of:

 house foreclosure


 car repossession

 IRS levy


 eviction from home or apartment


4. I/We understand and agree to provide **PHOTOCOPIES** of the following documents needed to analyze our case and prepare our case for filing bankruptcy, if applicable. No original documents are to be given to the attorney. Do not staple the photocopies of the documents (use paper clips only) as these documents may be electronically scanned. Assemble each category of documents separately and label the stack with a post-it note.


[check each box that is applicable]


 Driver's license(s).


 Last two filed Federal & State income tax returns.


 W-2's and 1099's (or returns) for the most recent calendar year.

 Paycheck stubs for both husband and wife for the last seven months, and any additional paycheck stubs received after retaining Sender & Wasserman and prior to the meeting of creditors.






















 Documents evidencing miscellaneous income for the last seven months (for example, commissions, bonuses, child or spousal support, unemployment benefits, trust fund, probate estate, gifts, gambling winnings, Social Security, disability, retirement pay, rents from tenants, interest & dividends, asset sales, etc.).





 Documents relating to any wage garnishment orders.

 Most recent monthly statements for all bank, credit union, stock brokerage and other similar accounts on which you have signatory authority.

 All statements, bills, notices, letters received from creditors and collectors in the last three months -- relating to all your debts including credit cards, medical bills, lawsuits, mortgage loans, personal loans, car loans, furniture loans, jewelry loans, etc.

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-  Documents relating to other personal property owned including, for example, stock value statements, cash value life insurance policy statements, retirement accounts, education IRA's, or tuition program accounts.
-  Any court orders setting child support or spousal support amounts that I should be paying or receiving, including the order setting regular ongoing monthly amounts and setting any monthly amounts for catching up on past-due support.
-  Copies of divorce decrees and/or permanent orders entered in the last four (4) years.
-  Pre-marital, pre-nuptial or post-nuptial agreements.
-  Documents relating to any education IRA or tuition program accounts.
-  Documents showing any criminal restitution payments I/we are required to make.
-  Documents relating to any bankruptcy I/we filed during the last eight years.
-  Documents relating to any trust or probate estate in which I/we have an interest, including any trust agreements.
-  Documents relating to any lawsuits or judgments filed against me/us.
-  Documents relating to any lawsuits or judgments filed by me/us against other people or companies.
-  For business debtors, balance sheet, plus profit and loss statement for the prior year and most recent month. Documents relating to self-employed individuals:
 -  corporation, partnership, LLC or other documents
 -  business inventory lists
 -  profit and loss statements
 -  balance sheets
 -  financial statements
 -  appraisals for business or business assets
 -  UCC-1 and other security and financing statements
 -  franchise agreements
 -  SBA/bank loan and security agreements

-  accounts receivable lists
-  stock/asset purchase agreements
-  equipment and vehicle lease agreements
-  business location or store lease agreements

Applicable Code Sections:

1. 11 U.S.C. § 523(a)(5) domestic support obligations are not dischargeable. Bankruptcy, Divorce, and Property Settlement 11 U.S.C Section 523(a)(15) obligations under a divorce decree or separation agreement
2. 11 U.S.C. § 541(a)(5)(A) of the Bankruptcy Code provides that “[a]ny interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date by bequest, devise, or inheritance.”
3. 11 U.S.C. § 548(a)(1) of the Bankruptcy Code states:

*The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, **that was made or incurred on or within 2 years before the date of the filing of the petition**, if the debtor voluntarily or involuntarily—*

(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor’s ability to pay as such debts matured; or

(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.