California Lawyers Association

presents

Bankruptcy Pitfalls for Non-Bankruptcy Attorneys

1.25 Hours MCLE

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1:45 PM - 3:00 PM

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Conference Reference Materials

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SELECT AUTOMATIC STAY ISSUES

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11 U.S.C. § 362

Upon the filing of a bankruptcy petition, a stay goes into effect automatically, prohibiting, among other things, the commencement or continuation, of an action against the debtor that was or could have been commenced before the commencement of the bankruptcy case.

SELECT AUTOMATIC STAY ISSUES

Relief from the automatic stay can be granted for, among other things, "cause." 11 U.S.C. § 362(d).

Cause may include continuing a lawsuit against the Debtor.

Factors may include:(1) Whether the relief will result in a partial or complete resolution of the issues. (2) the lack of any connection with or interference with the bankruptcy case. (3) Whether the foreign proceeding involves the debtor as a fiduciary. (4) Whether a specialized tribunal has been established to hear the particular cause of action and that tribunal has the expertise to hear such cases. (5) Whether the debtor's insurance carrier has assumed full financial responsibility for defending the litigation. (6) Whether the action essentially involves third parties, and the debtor functions only as a bailee or conduit for the goods or proceeds in question. (7) Whether litigation in another forum would prejudice the interests of other creditors, the creditors' committee and other interested parties. (8) Whether the judgment claim arising from the foreign action is subject to equitable subordination under Section 510(c). (9) Whether movant's success in the foreign proceeding would result in a judicial lien avoidable by the debtor under Section 522(f). (10) The interest of judicial economy and the expeditious and economical determination of litigation for the parties. (11) Whether the foreign proceedings have progressed to the point where the parties are prepared for trial. (12) The impact of the stay on the parties and the "balance of hurt."

In re Curtis, 40 B.R. 795, 799–800 (Bankr. D. Utah 1984).

SELECT AUTOMATIC STAY ISSUES

The automatic stay does not protect third-parties, such as co-obligors, co-defendants, guarantors, or a debtor's entity (even if wholly owned).

Query whether an alter ego of the debtor may enjoy the benefits of the automatic stay. *See, e.g., In re Frantz*, 602 B.R. 687, 694–695 (Bankr. E.D. Wis. 2019) ("If Frantz Ventures, L.L.C. is truly the alter ego of Frantz, as Raders alleges, then Frantz Ventures, L.L.C.'s property may be property of Frantz's bankruptcy estate, and whether property is property of a bankruptcy estate is a question Congress has long reserved to the bankruptcy court").

SELECT AUTOMATIC STAY ISSUES

The automatic stay does not stay actions commenced *by the debtor* (although it may not be prosecuted by the debtor unless abandoned by the Trustee).

Conversely, a defendant in an action brought by a plaintiff/debtor may defend itself in that action without violating the automatic stay. *In re Palmdale Hills Property, LLC*, 423 B.R. 655, 663 (9th Cir. BAP 2009) *aff'd* 654 F.3d 868 (9th Cir. 2011).

In *Lauriton v. Carnation Co.* 215 Cal. App. 3d 161 (1989), the state trial court granted defendant's motion to dismiss for failure to prosecute under Code of Civil Procedure Section 583.310, finding that the plaintiff's bankruptcy filing did not stay the action or otherwise divest the state court of jurisdiction.

"Where a plaintiff possesses the means to bring a matter to trial before the expiration of the five-year period by filing a motion to specially set the matter for trial, plaintiff's failure to bring such a motion will preclude a later claim of impossibility or impracticability." *Id*. at 165.

TOLLING DURING A BANKRUPTCY CASE

These slides are a starting point for more research

> ***Although the automatic stay is a broad and powerful provision, it does not stay the passage of time.***

Matter of Lauderdale Motorcar Corp., 35 B.R. 544, 548 (Bankr. S.D. Fla 1983).

TOLLING DURING A BANKRUPTCY CASE

Section 108(c) says:

If non-bankruptcy law, a non-bankruptcy order, or an agreement fixes a time for *commencing or continuing a civil action* (and such time has not expired before the filing of the bankruptcy petition), then the time is extended to the *later* of:

— the date that the deadline would otherwise naturally expire (including any possible extension of that date under state or nonbankruptcy law); or

— 30 days after notice of termination or expiration of the automatic stay.

TOLLING DURING A BANKRUPTCY CASE

Examples of actions tolled under § 108(c):

Ordinary statutes of limitation.

Renewal of Judgments. *In re Spirtos*, 221 F.3d 1079, 1081 (9th Cir. 2000); s*ee also In re Lobherr*, 282 B.R. 912 (Bankr. C.D. Cal. 2002) (judgment creditor's renewal of judgment during the pendency of bankruptcy case was not mere ministerial act, but was in nature of continuation of proceeding against debtor, of a kind prohibited by automatic stay).

Renewal / Continuation of Judgment Liens. *In re Swintek*, 906 F.3d 1100, 1102-1107 (9th Cir. 2018) (involving an ORAP lien and stating that "the period in which a creditor may enforce a judgment by executing on a lien constitutes the continuation of the original action that resulted in the judgment").

TOLLING DURING A BANKRUPTCY CASE

Mechanic's Liens? California law requires that an action be commenced within 90 days of recording or the mechanic's lien will be lost (note: recording the mechanic's lien can take place within the California statutory deadline without violating the stay – 11 U.S.C. § 362(b)(3))

In re Hunters Run Ltd. Partnership, 875 F.2d 1425, 1428 (9th Cir. 1989) (commencement of foreclosure proceedings under similar Washington statute is an "enforcement" which remains stayed by section 362, so section 108(c) applies to toll the enforcement period).

But see In re Baldwin Builders, 232 B.R. 406, 411 (9th Cir. BAP 1999) (finding that *Hunters Run* decided before certain amendments, and stating, "If no suit is timely filed, the lien becomes void").

But see In re 450 S. Western, LLC, 2021 WL 2528426, at *6 (Bankr. C.D. Cal., May 10, 2021) ("Philmont had not commenced an action to enforce its mechanic's lien. Therefore, to maintain the perfection of its lien, Philmont was required to file a notice maintaining perfection under § 546(b) within [the nonbankruptcy deadline]"); *aff'd sub nom.* 633 B.R. 894 (9th Cir. BAP 2021), *vacated and remanded* 2023 WL 2851378 (9th Cir. 2023) [unpublished].

TOLLING DURING A BANKRUPTCY CASE

When in doubt, file a "Section 546(b) Notice" Promptly (i.e., before expiration of the deadline)

Section 546(b)(2) says:

If—
(A) a law described in paragraph (1) *requires seizure* of such property or *commencement of an action* to accomplish [ ] perfection, or maintenance or continuation of perfection of an interest in property; and
(B) such property has not been seized or such an action has not been commenced before the date of the filing of the petition;

such interest in such property shall be perfected, or perfection of such interest shall be maintained or continued, *by giving notice within the time fixed by such law for such seizure or such commencement*.

TOLLING DURING A BANKRUPTCY CASE

Example of § 546(b) Notice:

"Pursuant to Section 546(b) of the United States Bankruptcy Code, 11 U.S.C. § 546(b), [name of creditor] hereby provides notice of the perfection of its lien interest and/or the maintenance and continuation of perfection of its lien interest in [describe property] of the Debtor, [name of debtor] (the "Debtor") created by virtue of [describe law / agreement]. [Creditor] is otherwise required to take certain action prior to the expiration of the lien to maintain or continue its interest, and [Creditor] hereby provides notice as a substitute pursuant to Section 546(b) of the United States Bankruptcy Code, 11 U.S.C. § 546(b), of the perfection of its lien interest and/or maintenance and continuation of its lien interest in all such [exempt and/or non-exempt] [real/personal] property of the Debtor."

TOLLING DURING A BANKRUPTCY CASE

Potential Trap: If you are relying in whole or in part on Section 108(c), then *don't forget to take action within the 30 days after notice of termination or expiration of the automatic stay (assuming that the discharge injunction replacing the automatic stay won't be violated)*!

Per 11 U.S.C. § 362(c)(1), as to an act against property of the estate, the automatic stay expires when property is no longer property of the estate (important for e.g., mechanic's lien enforcement actions)
Per 11 U.S.C. § 362(c)(2), the automatic stay expires at the earlier of:
(1) The time the case is **closed** [and, e.g. the debtor has been denied a discharge];
(2) The time the case is **dismissed**; or
(3) If the case is a Chapter 7 individual's case, or a case under Chapter 11 or 13, the time that a discharge is granted or denied.

In a Chapter 11 case, the automatic stay typically expires upon dismissal or confirmation of a plan of reorganization (among other times that it can expire). Note though that whenever a discharge is granted, the creditor will normally be prevented by the discharge injunction from taking any action.

TOLLING DURING A BANKRUPTCY CASE

What is Not Tolled?

Renewal of UCC Financing Statements (UCC-3s). *See* 11 U.S.C. §§ 362(a)(4), 362(b)(3), 546(b)(1); Cal. Comm. Code § 9515 Comment 4.

Acts taken in the bankruptcy case. Concerning a motion for attorneys' fees pursuant to Code of Civil Procedure § 685.040 (for enforcing a judgment), only fees incurred within two years of the fee motions were eligible for allowance. *In re Gilman*, 603 B.R. 437, 441 (9th Cir. B.A.P. 2019) *aff'd sub nom*. 836 Fed. Appx. 511 (9th Cir. 2020) (finding that creditor's non-dischargeability action was in furtherance of enforcement of a state court judgment).

SETTLEMENTS

SETTLEMENTS - BEFORE BANKRUPTCY

Problem: The Defendant makes a payment and then files bankruptcy 90 days later. The payment is subject to being clawed back by the bankruptcy trustee as a "preferential transfer." 11 U.S.C. § 547.

Pre-bankruptcy stipulations that a debt is non-dischargeable are unenforceable.

SETTLEMENTS - BEFORE BANKRUPTCY

Problem: The Defendant makes a payment and then files bankruptcy 90 days later. The payment is subject to being clawed back by the bankruptcy trustee as a "preferential transfer." 11 U.S.C. § 547.

Potential Solution #1: Obtain collateral from the Defendant, perfect the lien, and then make the first 90 days of payments as easy as possible for the Defendant. Even if the payments get clawed back (if any were made), the lien should survive the preferential transfer statute so long as the lien was perfected more than 90 days before the bankruptcy filing.

Note: The clawback period is 1-year if the transferee is an "insider."

SETTLEMENTS - BEFORE BANKRUPTCY

Problem: The Defendant makes a payment and then files bankruptcy 90 days later. The payment is subject to being clawed back by the bankruptcy trustee as a "preferential transfer." 11 U.S.C. § 547.

Potential Solution #2: Include a clause where, if the Defendant files bankruptcy before all payments are made, then Plaintiff may file a claim in the bankruptcy case for a greater amount. Warning: the amount must be liquidated damages, and not a penalty.

SETTLEMENTS - BEFORE BANKRUPTCY

Problem: The Defendant makes a payment and then files bankruptcy 90 days later. The payment is subject to being clawed back by the bankruptcy trustee as a "preferential transfer." 11 U.S.C. § 547.

Potential Solution #3: Include admissions in the settlement agreement that the Defendant stole, embezzled, converted, committed fraud, submitted a false written financial statement, etc. See exceptions to discharge in 11 U.S.C. § 523(a).

SETTLEMENTS - AFTER BANKRUPTCY

Problem: Once a *Plaintiff* / *Cross-Complainant* files a Chapter 7 bankruptcy petition, the bankruptcy trustee becomes the real party in interest because the litigation claims are property of the bankruptcy estate. 11 U.S.C. § 541(a).

Potential Solution for Plaintiff: File a Chapter 11 or Chapter 13 bankruptcy case and retain control. In a Chapter 7 case, seek to compel the bankruptcy trustee to abandon the litigation. Failing to provide notice to the Defendant of the bankruptcy filing is not a solution.

Potential Solution for Defendant: Approach the Chapter 7 Trustee and arrange a settlement!

Bartenwerfer v. Buckley
598 U.S. ____(2023)

These slides are a starting point for more research

Bartenwerfer...

11 U. S. C. §523(a)(2)(A)- A discharge does not discharge a debt arising, for money…obtained by…false pretenses, a false representation, or actual fraud…

The BAP said §523(a)(2)(A) barred her from discharging the debt only if she knew or had reason to know of David's fraud.

The Bankruptcy Court determined she had no knowledge on remand & the BAP affirmed.

The 9th reversed & held that a debtor who is liable for her partner's fraud cannot discharge that debt in bankruptcy, regardless of her own culpability.

Bartenwerfer…

So, how do you protect your client from the possibility that they may not get a discharge of debt under 523(a)(2)(A)?

- "Partnerships and other businesses can also organize as limited liability entities, which insulate individuals from personal exposure to the business's debts."

- "Individuals who themselves are victims of fraud are also likely to have defenses to liability."

- "…who is liable for fraud is a creature of state law — if state law did not extend liability for fraud to a partner, section 523(a)(2)(A) would not preclude discharge of that debt."

Select Family Law Matters

“One of the essential realities of marriage in a community property state like California is that community property generated in the marriage is liable for debts incurred by either spouse prior to marriage. Marriage brings many blessings but, in a community property state, this is one of the burdens. While the vows in a wedding ceremony in California do not typically include promises to pay the existing creditors of a spouse from the proceeds of all future community property, Section 910 of the California law creates such an obligation.”

These slides are a starting point for more research

FAMILY LAW MATTERS…

- **Marital Settlement Agreements-** *Subject to attack pursuant to 11 U.S.C. §548*
  - Did each of the parties receive fair and reasonable value? Or did one party receive more property/more debt than the other?
  - Need to be careful that one party does not get a disproportionate share of exempt assets- *In re Beverly*, 374 B.R. 221 (9th Cir. BAP 2007), aff'd, 551 F.3d 1092 (9th Cir. 2008)
  - Do a "detailed analysis"
  - Get an order from the family law court before the bankruptcy is filed- Collateral Estoppel
  - If you can "litigate it" do so

- ***11 U.S.C. § 547(c)(7)-*** Excludes DSO from preference actions, therefore, if you are representing a party in a divorce and you are concerned about a possible bankruptcy filing creating "clawback" rights, have the payment characterized as a DSO

FAMILY LAW MATTERS…

- **Whether to file jointly or not-**
  - Can the parties work together?
  - Is there benefit to filing separately so that each spouse can claim a set of exemptions on their portion of the property once divided?
  - If a cap will apply to the homestead exemption should they file together while the property is in the hands of both? 11 U.S.C. 522(m)
  - "Beauty and the Beast" tactic to avoid liability to both? *See* 524(a)(3).
  - Will support obligation help either party?
  - Will joint budget assist in accomplishing lawful Chapter 7 filing?
  - Will the debts total assist in qualification?

FAMILY LAW MATTERS…

Timing is everything-

- Talk to a bankruptcy attorney before any indemnification agreement because it is non-dischargeable in Chapter 7 pursuant to *11 U.S.C. §523(a)(15)*-

  "(a) A discharge under section 727, 1141, 1192 [1] 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

  (15) to a spouse, former spouse, or child of the debtor and not of the kind described in paragraph (5) that is incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court of record, or a determination made in accordance with State or territorial law by a governmental unit…"

- If your client needs to discharge something that is not a "support" obligation [defined in 11 U.S.C. § 101(14A)] excluded from the discharge under *§523(a)(5),* then your client should file a Chapter 13 which **can** discharge a debt in (a)(15), like an equalization payment or attorney's fees.
- If you are an attorney owed attorney's fee, make sure the debtor ends up in a Chapter 7, so you can still get paid on fees "incurred…in connection with…" a family law matter.

FAMILY LAW MATTERS…

Timing is everything-

- If you have community property ("CP") that you cannot get divided (contentious party on the other side, for example) and you want it divided and used to pay community debts, filing a bankruptcy is a great way to accomplish an orderly liquidation the CP to pay community debts and then separate debts
- Make sure the family law court order is ENTERED if you want to keep ½ of CP out of the bankruptcy estate- See *In re Nassar*, No. 2:15-bk-11540-ER (Bankr.C.D.Cal. 2015).
- If you can have your fees characterized as a "support" obligation, you can avoid discharge of your fees in Chapter 7 or 13. See *Voss v. Voss* (In re Voss) (B.A.P. 9th Cir. 2020) (Court determined that an attorney's fee award was not dischargeable because it was in the nature of "support.")

Business Debtor Issues

These slides are a starting point for more research

Business Debtor Issues…

- Is a Corporate Chapter 7 bankruptcy really the solution?
  - Often, deadly to the principles/owners
  - No discharge in a corporate case- What is the purpose?
  - Liquidation of assets (forced dissolution)
  - Severs alter ego claims/successor liability claims for new corporation
  - ***Ability to settle claims that the corporation owns/holds against insiders or others***
- If you represent a shareholder who wants dissolution think about filing a bankruptcy for the corporate entity to liquidate assets BUT make sure you have authority or you could face claims that the case was an involuntary case and be subject to damages. 11 U.S.C. Section 303.
- In drafting operating agreements, make sure the appropriate person has authority to put the entity into bankruptcy

Business Debtor Issues…

- Limitations on "landlord deficiency claim" pursuant to *11 U.S.C. §502(b)(6):*

  "(6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—

  (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—

  (i) the date of the filing of the petition; and

  (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus

  (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates…"

- Similar limitation of "severance payments" pursuant to *11 U.S.C. §502(b)(7)*

Bankruptcy may be your friend

These slides are a starting point for more research

Bankruptcy to your benefit…

- Creditors/Plaintiffs- "What you don't know…can hurt you!" – Think about filing an involuntary bankruptcy pursuant to 11 U.S.C. 303(a):
  - Get the information/documents needed- 341(a) testimony, 2004 Exams & Subpoenas
  - Limitations on the homestead exemption under 11 U.S.C. Section 522
    - 10-year look back for assets used to create equity in residence with "intent to hinder, delay, and defraud" [522(o)];
    - Homestead exemption limited/capped on residence purchased in 1215-period excluding value transferred from prior residence [522(p)];
  - Certain non-dischargeable actions/statements are limited to within the 1-year prior to filing period [727(a)(7)]
  - Catching avoidable transfers, preference payments, and non-exempt assets
  - Tread lightly, though, in filing an involuntary, as a damages award can be issued [303(i)]

Potpourri of Miscellaneous Issues

These slides are a starting point for more research

Exemption Issues….

- California increased its Homestead Exemption ("HSE") in 2021 (See CCP 704.730)
- With the statute change has come an increase in litigation/scrutiny over HSE's
- With the pandemic has come a movement of people affecting exemptions applicable to a client [*See* 11 U.S.C. 522(b)(3)]
- Limitations on the HSE pursuant to 11 U.S.C. Section 522 (discussed above)
- Make sure your client's home is held in their name (preferably)-
  - See *Schaefers v. Blizzard Energy, Inc. (In re Schaefers),* 623 B.R. 77(B.A.P. 9th Cir. 2020) which disallowed debtor's homestead exemption in debtor's residence held in an LLC
  - Compared to *In re Nolan*, 618 B.R. 860 (Bankr. C.D. Cal. 2020) (affirmed by the Ninth Circuit) in which the bankruptcy court allowed the debtor's automatic homestead exemption in a beneficial interest in a trust that held title to the debtor's residence.
  - But, transfer of title to residence from single member LLC to individuals' names just days before filing his bankruptcy triggered 522(p) cap. See *Kane v. Zions Bancorporation* (N.D. Cal. 2022)
- If your client suffers a judgment they can use 11 U.S.C. Section 522(f) to avoid a judgment lien on residence

Tax Issues…

- Taxes are dischargeable under certain circumstances- 11 U.S.C. 523(a)(1) excludes taxes from discharge that do not meet the requirements in 503(a)(3) and (8), generally= *3 year, 2 year, 240 day rule*

- **See a bankruptcy attorney before a tax lien is placed on client's assets/residence**
  - Bankruptcy trustees are selling debtors' residences that are subject to a tax lien and not paying the debtor(s)' homestead exemption based on avoiding and preserving the tax lien pursuant to Section 11 U.S.C. §§ 724(a) and 551
  - However, once the property has been determined exempt it is removed from property of the estate and not subject to sale by the Trustee. See *United States v. Warfield (In re Tillman)*, 53 F.4th 1160 (9th Cir. 2022).

JUDICIAL ESTOPPEL…

A debtor "is judicially estopped from asserting a cause of action not raised in a reorganization plan or otherwise mentioned in the debtor's schedules or disclosure statements" because "both the court and [the debtor's] creditors base their actions on the disclosure statements and schedules." *Meyer v. Nw. Tr. Servs. Inc.* (9th Cir. 2017) citing *Hamilton v. State Farm Fire & Cas. Co.,* 270 F.3d 778, 783, 784 (9th Cir. 2001).

Are you litigating against a party that previous filed a bankruptcy?

- Did they list claims against your client they seek to collect on now?
- Did they make other statements that are inconsistent with the positions they are taking in litigation elsewhere? (Example: income and expenses, other creditors, total of debts, etc.)

Subchapter V of Chapter 11…The New Kid on the Block

- ✓ *"Cramdown" for a business*
- ✓ *Disclosure statement not required (but can be ordered)*
- ✓ *No absolute priority rule*
- ✓ *Sub V Trustee and no US Trustee's fees*
- ✓ *Consensual plan vs non-consensual plan*