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CONSUMER CASE AVOIDANCE ISSUES

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CONSUMER CASE AVOIDANCE ISSUES

Creditors' lawyers need to understand the impact of a bankruptcy filing by a debtor when the creditor is pursuing claims against the transferees of the debtor's assets. In certain cases a creditor should welcome the involvement of the Chapter 7 Trustee, whereas in other instances, a creditor can be frustrated when a Chapter 7 Trustee fails to aggressively pursue the recovery of such a transfer. More importantly, creditors need to fully comprehend this issue because once a bankruptcy is filed, any recovery by the Chapter 7 Trustee is for the benefit of all creditors, not just the specific creditor which may have been previously pursuing such a claim. Because of this latter concern, in many cases, it may be advantageous for a creditor to seek an abandonment of a fraudulent transfer claim from the bankruptcy estate, or try to negotiate an agreement with the Chapter 7 Trustee to ensure that a specific creditor willing and able to pursue such a claim receives a recovery which compensates that creditor for its financial investment and participation in the process.

The following is an overview of options available to a creditor and a bankruptcy Trustee when an innovative debtor has engaged in any type of pre-bankruptcy engineering.

This outline is not designed to be a didactic study on avoidance issues that arise in all types of consumer bankruptcy cases. Instead, it will alert the practitioner as to issues which commonly surface so that the practitioner can properly prepare for such issues and avoid them when possible.

I. UNDERSTAND HOW PREFERENCES AND FRAUDULENT TRANSFERS CAN IMPACT ON A CONSUMER CHAPTER 7

The following is boilerplate I provide my individual clients receiving bankruptcy protection. Please note that one outline addresses cases which consist primarily of consumer debt, whereas the other outline discusses the subtle differences that exist when the majority of the debt is non-consumer. The law also was amended effective February 19, 2020, to make it more difficult to pursue a preference claim in a number of different instances.

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FRAUDULENT TRANSFERS AND PREFERENCES

(Consumer Debt)

Certain transfers and payments are prohibited under the Bankruptcy Code. These prohibitions were designed to ensure that individuals contemplating bankruptcy do not dispose of their property to place outside the reach of creditors or pick and choose certain creditors to pay unless certain rules are followed.

A fraudulent transfer is any transfer of property for which inadequate consideration is received at a time in which the transferor is insolvent or rendered insolvent by the transfer. Insolvency is generally defined as having debts that

exceed your assets. If such a transfer occurs within two years of filing bankruptcy, and in certain instances, even longer, the bankruptcy trustee has the right to recover the property or an amount equivalent in cash from the transferee.

A preference is a payment made within 90 days of bankruptcy on account of an old debt and in the case of insiders, within one (1) year of bankruptcy. There are exceptions to this rule, but if a preferential payment is made, the trustee may recover the payment from the recipient. A preferential payment does not have to be in the form of cash; any transfer received from a third party within the statutory guidelines on account of an old debt can create a preference.

Starting in 2003, the U.S. Trustee's Office has demanded that debtors disclose whether they have renounced any interest in any estates within four years of bankruptcy. This question is being asked because if an individual has renounced such an interest, the U.S. Trustee's Office believes that such action may be a fraudulent transfer. It may be a fraudulent transfer because in certain instances, if the debtor has exercised control over that estate interest, renouncing it in advance of bankruptcy may be a designed effort to deprive creditors of that same interest upon the filing of a bankruptcy. This is not to suggest you do not have a right to renounce an interest in a will or a trust within four years of bankruptcy, but there may be a situation in which such activity can be challenged.

Because there are many intricate rules and a number of exceptions, you need to consult with me about any transaction that may be fraudulent or preferential. Sometimes there are ways to reverse or rectify the transaction in advance of bankruptcy and by doing so, eliminate the problem.

PREFERENCES AND FRAUDULENT TRANSFERS

(Non-Consumer Debt)

Certain transfers and payments are prohibited under the Bankruptcy Code. These prohibitions were designed to ensure that individuals contemplating bankruptcy do not dispose of their property to place outside the reach of creditors or pick and choose certain creditors to pay unless certain rules are followed.

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Some attention has to be paid to this issue for a number of reasons. First of all, in certain instances you may want to delay the bankruptcy filing if a crucial vendor has received what would be a preferential payment which you as the debtor do not want to have to reverse. Occasionally by waiting a few days, that payment will be taken outside the preference period, which could help facilitate future dealings with that creditor.

Finally, in cases in which you may be paying vendors and creditors right before bankruptcy, those creditors can avoid potential preference problems by making sure that such payments are credited to the most recent invoices since a payment that is made for a recent charge would not be on account of an antecedent debt and therefore not preferential.

Please note that since this is a business case, preferential payments made that total less than $6,425 are not preferential, nor can a trustee pursue out of state vendors whose payments may be have exceeded $25,000 without actually bringing an action in the vendor's home State.

Because there are many intricate rules and a number of exceptions, you need to consult with me about any transaction that may be fraudulent or preferential. Sometimes there are ways to reverse or rectify the transaction in advance of bankruptcy and by doing so, eliminate the problem.

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From the onset, it's crucial that the consumer lawyer understands these differences and advises clients accordingly. It's very important to differentiate between the two types of cases for the following reasons.

a. If your client does not want the payment to be avoided, this can normally be accomplished by proving the majority of the debt is non-consumer.

b. A trustee will be less inclined to file an adversary if the case has to be filed in the recipient's jurisdiction, which is the case with smaller claims in non-consumer cases.

c. If the debtor wants the payments to be avoided, then having the claim classified as a consumer one will obviously increase the chances of that happening in many instances. However the debtor and counsel need to remember that Chapter 7 eligibility may be challenged if the case is a consumer one, whereas it may not be if it is not.

d. In certain cases, a debtor will not have to delay the filing because of the preference statutory period if the case is a non-consumer one.

In certain scenarios, timing the filing so that the payments fall within the statutory period could be very beneficial to the debtor.

II. WHEN TIMING OF THE FILING CAN BE BENEFICIAL

When your client is facing a large priority and/or non-dischargeable tax claim, your client has incentive to want to maximize what is available in the estate to pay such claims. One way of doing so with little risk to the debtor is to file the case within the statutory preference period so that the trustee will recover those payments for the benefit of priority creditors of the estate like the IRS or the Department of Revenue. Oftentimes, the debtor may have had monies or assets seized by a judgment creditor, which will be subject to reversal if the case is filed within 90 days of that payment. In other instances, the debtor may have made voluntarily payments and after the fact recognized that those payments should have been directed towards a creditor which otherwise would not be discharged in a bankruptcy case. During the course of my career, I have seen many cases in which these factors were simply not considered to the detriment of the debtor. Therefore, upon being retained by the client, immediately conduct this analysis because sometimes a looming deadline requires an accelerated filing date.

III. PRE-BANKRUPTCY PLANNING

The following is the discussion I provide every client who is even considering pre-bankruptcy planning. I never advise clients to engage in pre-bankruptcy planning, I simply outline the options and let them decide accordingly. Not surprisingly, in all but one or two cases during my career, the client chose to engage in the planning instead of simply turning over non-exempt assets to his or her bankruptcy trustee.

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PRE-BANKRUPTCY PLANNING

> Pre-bankruptcy planning is the converting of non-exempt assets into exempt assets. This practice is not illegal or improper; Bankruptcy Code legislative notes specifically permit this type of activity. This is not to say that this procedure is without risk.

In July of 1996, In re Elia became the first Arizona published opinion on pre-bankruptcy planning. The judge found nothing inappropriate with buying a house right before bankruptcy and other similar strategies. However, that case is persuasive but not binding on the other judges. In other courts throughout the country, this issue has been addressed and in certain instances, the pre-bankruptcy planning vilified by the bankruptcy judges. Though no single test has been universally accepted by the courts in determining whether or not to tolerate pre-bankruptcy planning, a number of criteria continuously surface in case after case:

1. What is the amount of the transfer to exempt property?

2. What is the proximity to the bankruptcy filing?

3. Did the conversion to exempt property involve newly acquired funds or previously secured property?

4. Did the conversion benefit insiders of the debtor?

5. Did the debtor mislead creditors during the conversion?

Other courts have considered additional circumstances in determining whether or not the pre-bankruptcy planning is reproachable, but the best way to summarize whether or not pre-bankruptcy planning will succeed is to consider the old maxim, "pigs get fat, and hogs get slaughtered."

Your attorney would also be incurring some risk if the planning progresses to a stage where it could be interpreted as a fraud upon creditors. Though normally the bankruptcy courts do not sanction the attorneys for the planning, but rather punish the debtors, in past non-bankruptcy settings, the Arizona courts have penalized attorneys for overly zealous asset protection tactics.

Debtors whose pre-bankruptcy planning has been successfully challenged face a number and variety of repercussions. Oftentimes, the courts order that transfers be set aside and/or reversed. For example, if a debtor has utilized cash to increase his homestead by $50,000 in advance of bankruptcy, an intolerant court can either require that the debtor find the means to replace the $50,000, or, in extreme circumstances, compel the debtor to sell the exempt property and remit $50,000 to the estate. In certain instances, reversing what has occurred is simple while at other times generates a new set of problems for the debtor.

In some situations, courts have found the pre-bankruptcy planning to be so egregious as to justify the denial of a discharge. Though this result is rare, being deprived of a discharge defeats the entire reason behind bankruptcy and is disastrous for the debtor. **This risk is now even more pertinent because of the following change in the law.**

> One of the changes in the bankruptcy law which went into effect on April 20, 2005, specifically provides that the Court has the power to reduce a state law homestead exemption by any transfers of nonexempt property made to increase that exemption for an extended period of time (10 years) prior to bankruptcy filing if such transfers were done in fraud of creditors. Though this has always been the law, this change now incorporates the case law into the Bankruptcy Code itself although courts have been inconsistent in their enforcement of it. Unfortunately for you, it may increase the chances that your pre-bankruptcy planning could be successfully challenged, though you may still need to engage in the planning nevertheless.
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> **The BAPCPA was specifically designed to discourage debtors from engaging in pre-bankruptcy planning and in particular to stop the practice of Chapter 7 debtors paying down their mortgages in advance of bankruptcy. Some experts have even gone so far as to recommend that pre-bankruptcy planning be limited.**

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Judges seem to apply both an objective and subjective standards in determining whether the planning is appropriate. That being said, since I have both challenged planning cases and defended them, I have concluded that the following factors are crucial to the ultimate outcome of such litigation.

1. Was the debtor forthright in all disclosures – Regardless of the planning that may have occurred, the failure to disclose the different transfers creates grounds to deny a debtor's discharge. Even justifiable transfers have to be painstakingly outlined in the Schedules because a trustee is reposed with an absolute statutory responsibility to investigate them. When material transfers are not disclosed, the trustee's job is made far more complicated or, in some cases, impossible to perform, and the Court may not even care if the transfers were otherwise insignificant.

2. Show proper grounds for the transfers – The Courts will tolerate debtors trying to obtain a fresh start. The Courts are not so tolerant of individuals seeking a "head start." When I'm representing debtors in complex high-debt cases, I try to set the stage from the onset in proving that the clients had no choice but to file for bankruptcy and engage in some of the planning. Or, more importantly, that the planning makes solid economic sense going forward. That's why when I have had a client who may has the resources to pay off a second mortgage on a homestead, I will have the client pay off the second mortgage if possible since doing so reduces the client's monthly obligation going forward. When clients otherwise pay down or pay off mortgages on their homestead, I try to demonstrate why it makes solid economic sense separate and apart from the bankruptcy filing. Please note that some of these factors are both subjective and objective, but I try to use what I call "the reasonable man standard." If I have a client with an older beat up vehicle for which he owes $6,000 and the vehicle is worth $6,000, I never hesitate to have the client pay off that lien against the vehicle. On the other hand, when a client has a brand new $100,000 Mercedes which is encumbered up to the hilt, I'm a little nervous having that client pay down that

debt by $6,000 since a high likelihood exists that the judge is not driving as nice a car.

3. Show bankruptcy was unavoidable – Without question, it always helps to be able to demonstrate that the clients had to file for bankruptcy and that is why they engaged in the planning. It is very difficult to defend a case in which clients were forced to file for bankruptcy partially because of the pre-Petition planning itself. In other words, it is dangerous to pursue a case in which the clients could have settled by utilizing the very monies that the client was trying to sock away through planning. Be in a position to prove to the Court that even if the clients had not engaged in any of the planning, bankruptcy would have been inevitable. That is why I am pleased when creditors turn down pre-Petition offers comprised of all of the client's non-exempt property because in those situations, the creditors cannot argue that the bankruptcy was avoidable. The Court will see that the very creditors that may object to the debtor's conduct are the very creditors which forced the debtors into bankruptcy.

4. Consider the amount of planning relative to the debt – If a client is facing $500,000 in debt and engaging in $25,000 worth of planning, creditors are really not being damaged by the planning. In contrast is a case in which a client owes $100,000 and engages in $100,000 worth of planning. Clearly, in the latter case, the planning is depriving the creditors of a substantial return. Once again, the Bankruptcy Code doesn't specifically state that the relationship of the amount of debt to the planning should make a difference, but it does.

5. The derivation of the debt can be important – If your client is facing bankruptcy because of unexpected and horrendous medical bills or because of an overwhelming casualty-type claim, the client may engender sympathy versus the individual seeking bankruptcy because of over-aggressive business dealings. Similarly, elderly adults facing overwhelming debt because of the loss of a spouse who engage in planning to ensure that individual can maintain some semblance of a lifestyle will normally not face a challenge to the planning.

6. Consider what the debtor is really trying to accomplish – I always try to consider the consequences of the debtor not engaging in the planning relative to the planning itself. A debtor buying an inexpensive condo with available cash who may have little income potential and would have difficulty paying rent will probably not face the same challenge as a person reducing his million dollar mortgage by $100,000 which will otherwise have no impact on that individual's financial situation.

Finally, when assisting a client with planning, be totally intellectually honest with the person you are trying to help. *See* In re Beverly, 374 B.R. 221 (9th Cir. BAP 2007). A lawyer facing a large malpractice claim enlisted the assistance of his estranged wife to help him avoid the consequences of his wrongdoing by conveying to her pre-bankruptcy his non-exempt assets. The court denied his discharge in response. Besides the case teaching the obvious lesson of never reducing to writing your true intentions, *i.e.*, to avoid paying your creditors, you need to ask yourself whether your client is generally a decent individual. I'm not suggesting that you cannot or should not represent a client that may not be the nicest person in the world, but remember that in the end the judge will have to take a deep breath and decide whether your client is deserving of bankruptcy relief and if you hesitate in answering the question yourself, the judge may have the same reaction.

IV. WHAT HAPPENS WHEN A BANKRUPTCY TRUSTEE IS UNWILLING TO PURSUE A FRAUDULENT TRANSFER CLAIM?

This issue arises in two distinct contexts. In certain cases, for a variety of different reasons, a Chapter 7 trustee may be hesitant to pursue a fraudulent transfer claim even though your creditor client believes it is a viable one. The other time this issue arises is when a Chapter 11 debtor refuses to do so either because the debtor-in-possession doesn't believe the claim is worth pursuing or doesn't want to for personal or business reasons.

In the former case, one option available to a creditor is to ask for the appointment of an alternate trustee at the first meeting of creditors. This rarely used option provides a creditor with the absolute right to have an alternate trustee appointed as long as the statutory requirements are met, which includes demonstrating that the petitioning creditor possesses at least 20% of the claims and the proposed trustee is otherwise qualified. *See* 11 U.S.C. § 702.

The other alternative, which is one rarely used, allows a creditor in certain instances to request the abandonment of the claim if the trustee is otherwise unwilling to pursue it even with the assistance and encouragement of the creditor. In certain instances, if the trustee concedes that the claim has no value for the estate, the Court will allow for the abandonment of the claim back to the creditor, which under State law would normally have the right to pursue it.

The majority of the Federal Circuit Courts of Appeal have allowed creditors to pursue fraudulent transfer claims when; 1) the Bankruptcy Court approves the creditor's standing; 2) the trustee is unwilling or unable to assert the claim or causes of action on behalf of the estate; and 3) allowing the creditor to pursue the claims is likely to benefit the estate.

Instead of trying to pursue the claim in a Chapter 11, a more common option is for the creditor to request either the appointment of an independent trustee for the Chapter 11 case or even conversion in extreme cases to a Chapter 7. Interestingly enough, a Chapter 11 debtor's attorney needs to be very cognizant of this possibility when filing a Chapter 11 case. Inexperienced lawyers oftentimes forget that their clients are reposed with an absolute statutory duty to take appropriate steps to maximize recovery for creditors and ignoring potential recovery, either because of a preferential or fraudulent transfer, can lead to the unpleasant result of having a Chapter 11 trustee assigned or even the case being converted.

This of course forces a lawyer from the onset to have to consider whether it even makes sense to ever try to place an individual into a Chapter 11 bankruptcy if that individual has engaged in extensive transactions with insiders or friendly parties which could trigger preferential or fraudulent transfer claims. It's very difficult to successfully convince creditors or a bankruptcy judge that your client is dealing in good faith when target defendants consist of family members or individuals with close personal relationships with the debtors.

It's not impossible to successfully represent debtors in such a situation, but it is absolutely crucial that you recognize the sensitivity of the situation.

V. WHEN CAN A CREDITOR PURSUE A FRAUDULENT TRANSFER CLAIM EVEN IF THE TRUSTEE HAS DONE SO

Since a bankruptcy trustee is empowered to pursue fraudulent transfer claims implemented by the debtor, creditors pursuing those claims pre-bankruptcy usually have to defer to the trustee and are no longer allowed to pursue such claims. In certain cases, this can be very frustrating to the creditor, especially in cases in which the creditor does not believe that the trustee has exhausted all recourse.

In this situation, the creditor cannot rely upon arguments that the trustee has abandoned such claims since the trustee has not.

Though there is little case law on this issue, the case law all suggests that a creditor is limited from bringing those claims to circumstances in which the claims against third parties transferees are not based upon fraudulent transfer or similar theories.

Judge Haines, in Hoyt v. Aerus Holdings, L.L.C., 447 B.R. 283 (Bkrtcy. D. Ariz. 2011), prevented creditors from pursuing third parties and concluded that claims owned by the bankruptcy trustee could not be pursued by those creditors unless the bankruptcy trustee has abandoned those claims. He so ruled in the face of creditor arguments that the claims being pursued by them could be differentiated from traditional fraudulent transfer claims.