

BANKRUPTCY - CURRENT ISSUES AND IMPACT ON OTHER PRACTICE AREAS

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I. INTRODUCTION

Although you may not practice bankruptcy law, it likely - almost a certainty - that, at some point in time, bankruptcy will impact upon a case or matter you are handling. The bankruptcy may stay pending litigation; it may move the litigation to a different forum; it may require that you or opposing counsel obtain Bankruptcy Court authorization for employment as counsel; it may eliminate a judgment lien recently obtained; or it may change the terms the parties deem acceptable for a settlement of a matter. The litigation or matter you are handling may not be the object of the bankruptcy filing. Some bankruptcy cases are filed as a part of litigation strategy, but most bankruptcy cases are filed for economic reasons. Moreover, although most bankruptcy cases are filed voluntarily, creditors or partners can file an involuntary petition against an alleged debtor. In virtually all cases, the course of non-bankruptcy litigation will be impacted, even if only temporarily.

This session and these materials are not intended to address all possible scenarios and implications of bankruptcy; rather, this session addresses several selected aspects of bankruptcy law and several recent developments in bankruptcy law that may impact litigation in other practice areas.

II. THE AUTOMATIC STAY

- A. The Stay. The filing of any bankruptcy invokes the automatic stay under 11 U.S.C. §362(a). A copy of §362(a) is attached as Exhibit A to these materials. As the term “automatic stay” implies, the stay becomes effective immediately upon the filing of the bankruptcy case, by operation of law and without entry of a stay order. The stay is applicable actions to recover claims against the debtor that arose before the filing of the bankruptcy; the enforcement against the debtor or against property of the bankruptcy estate of a judgment obtained before the filing of the bankruptcy case; any act to obtain possession of property of the bankruptcy estate or to exercise control over property of the estate; any act to create, perfect, or enforce a lien against property of the estate; and other types of debt collections proceedings.
- B. Exceptions. The automatic stay does not apply to the commencement or continuation of a criminal action or proceeding against the debtor, to an action or proceeding by a governmental unit exercising its policy and regulatory powers, or to a few other exceptions, for special matters, set forth under §362(b).
- C. Duration of the Stay. The automatic stay is effective until the earliest of (1) the time the case is closed; (2) the time the case is dismissed; (3) the time a discharge is granted or denied; or (4) if the stayed matter concerns property of the estate, at the time the property is no longer property of the bankruptcy estate. 11 U.S.C. §362(c). Note: If the debt has been discharged, further collection efforts are enjoined under 11 U.S.C. §524.

D. Relief from the Stay. Relief from the automatic stay may be obtained under §§362(d) upon the grounds set forth in §§362(d)(1) and/or (2). Much litigation occurs over whether relief from the automatic stay is appropriate in a given situation. Relief from the automatic stay is sought by motion, which is governed by Rule 4001(a) of the Federal Rules of Bankruptcy Procedure and Rule 4001-1 of the Local Rules of the United States Bankruptcy Court for the District of South Carolina.

E. Violation of the Stay. A willful violation of the automatic stay is a serious offense. Section 362(h) provides as follows: “An individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys’ fees, and, in appropriate circumstances, may recover punitive damages.”

It is important to note that, even though a creditor or party may not have received written notice of the bankruptcy filing, upon receiving information that the debtor has filed a bankruptcy, it is that party’s responsibility to reasonably attempt to verify whether the bankruptcy has been filed. A creditor or party that disregards information that a bankruptcy has been filed may be held in contempt for violation of the automatic stay, even if that party has not received written notification of the bankruptcy.

III. TYPES OF BANKRUPTCY

Below is a short description of each type of bankruptcy case.

A. Chapter 7. A Chapter 7 bankruptcy case involves the liquidation of the debtor's assets. This type of bankruptcy is often referred to as "straight bankruptcy", or, for individuals, the "fresh start". All property owned by the debtor, or in which the debtor has an interest, as of the date of the bankruptcy filing becomes property of the bankruptcy estate. A Chapter 7 bankruptcy trustee is appointed, who is charged with the responsibility of liquidating assets to generate funds to pay unsecured creditors. To this end, the Chapter 7 bankruptcy trustee looks to find assets which are unencumbered, or which have sufficient equity to generate payment to unsecured creditors. It is presumed that secured creditors will both be able and motivated to protect their interests in their collateral. Accordingly, if assets are fully encumbered, or if assets are fully exempt, the trustee will abandon the assets.

Individuals file this type of bankruptcy to obtain a discharge, meaning that they will be relieved of personal liability for most debts. Certain debts such as income taxes incurred within the three years preceding the bankruptcy, or unpaid trust taxes, or child support or alimony payments, are not dischargeable in the bankruptcy case. 11 U.S.C. §§523(a) and (c).

In addition, the debts may be excepted from the discharge, such as where a debt has been incurred by fraud. Id.

Individuals may exempt certain types of property, in limited amounts of equity, from the bankruptcy estate. The bankruptcy statute providing for bankruptcy exemption, 11 U.S.C. §522, provides that each State is to set exemptions applicable to cases filed within that State.

In South Carolina, the bankruptcy exemption generally are set forth under S.C. Code 15-41-30 (1976, as amended).

- B. Chapter 13. Only individuals may file Chapter 13 bankruptcy cases, which involve plans for payment of creditors through a Chapter 13 bankruptcy trustee. The plans may extend a maximum of five (5) years. The debtor must pay creditors as much as they would receive in a Chapter 7 bankruptcy case. However, the debtor is not required to pay all debt, provided that the creditors receive payment at least equal to the payment they would receive in a Chapter 7 bankruptcy, and provided that the debtor is committing all of the income reasonably available toward payment of the creditors.

- C. Chapter 11. Chapter 11 is referred as “reorganization”, though it may involve a voluntary, orderly liquidation of assets. Individuals may file a Chapter 11 bankruptcy case, however, typically these cases involves commercial or business enterprises. Chapter 11 cases are expensive and administratively complex.

In most Chapter 11 cases, the debtor remains in possession and control of the debtor’s property, as the “debtor-in-possession”. A trustee is not normally appointed, unless there is a showing of compelling cause. The debtor-in-possession has the rights and powers of a bankruptcy trustee; the debtor-in-possession also has corresponding fiduciary duties to the bankruptcy estate and its creditors.

Although many districts, including the District of South Carolina, have local rules requiring that the debtor-in-possession file a plan of reorganization by a specified time, there is no absolute deadline for filing a plan. In South Carolina, Local Rule 2081-1(c) requires that the plan be filed within one hundred eighty (180) days after the commencement of the case; however, this time may be extended where appropriate. In some cases, an extended period - even over one year or two years - may be appropriate. In most cases, a much shorter time will be allowed for filing a plan, and the pressures of the case (e.g., business exigencies or creditor issues) often compel the filing of a plan at a particular date.

D. Chapter 12. This type of bankruptcy was created specifically for family farmers. It is a hybrid of Chapter 11 and Chapter 13, in recognition that neither of those types of reorganization adequately address many considerations peculiar to farming. The debtor remains in possession and control of his assets, but a Chapter 12 trustee is appointed to monitor the case, to receive and disburse most plan payments to creditors, and to otherwise administer the bankruptcy estate.

E. Chapter 9. This chapter addresses bankruptcy filings by municipalities and state entities. Only two Chapter 9 cases ever have been filed in South Carolina. The largest and most notable Chapter 9 bankruptcy case filed was the case of Orange County, California.

IV. BANKRUPTCY IMPACT ON PENDING LITIGATION.

- A. Stay of Litigation. The automatic stay will apply to litigation against the debtor, or against property of the debtor's bankruptcy estate. 11 U.S.C. §362(a). However, litigation in which the debtor is the plaintiff, or the appellant pursuing an appeal, is not stayed.
- B. Possible Change In Forum. The bankruptcy filing may result in a change in the forum in the which the litigation or matter will be adjudicated.
1. Jurisdiction of the Bankruptcy Court.
- a. Pursuant to 28 U.S.C. §1334(a), the United States District Court has original and exclusive jurisdiction over all bankruptcy cases, and pursuant to §1334(b), the District Court has original but not exclusive jurisdiction of all civil proceedings arising under the Bankruptcy Code (11 U.S.C. §101 et. seq.), or arising in or related to cases under the Bankruptcy Code.
- b. Pursuant to 28 U.S.C. §157(a), the District Court may provide that any or all proceedings arising under title 11 (the Bankruptcy Code), or arising in or related to a case under title 11 be referred to the Bankruptcy Court. In the District of South Carolina, Local Civil Rule 83.X.01 provides for this referral to the Bankruptcy Court.

c. The District Court may withdraw the reference to the Bankruptcy Court, in whole or in part, on its own motion or on the timely motion of any party, for cause shown. 28 U.S.C. §157(d).

2. Core Proceedings. Core proceedings are matters which must be heard in the Bankruptcy Court. Attached as Exhibit B to these materials is a copy of 28 U.S.C. §157(b), which provides a list of most matters deemed to be core proceedings; the list is an “including but not limited to” listing. Core proceedings are deemed to be central to the bankruptcy case and its administration.

Many matters in litigation prior to a bankruptcy will be deemed to involve core proceedings, and, hence, the litigation of the issues will be conducted in the bankruptcy court. For example, a “slip and fall” case will become a matter of determining an asserted claim against the bankruptcy estate. Most claims litigation is conducted in the Bankruptcy Court. In some instances, however, such as where litigation has reached an advanced stage in another court, the Bankruptcy Court may allow the completion of the adjudication in the other court, usually for the limited purpose of determining the issues (e.g., the validity and amount of an asserted claim) without entry of further relief by that court.

3. Non-Core Proceedings. Non-core proceedings which do not involve bankruptcy law, in many cases, may be heard in the court in which the proceedings would normally

be heard. However, where the matter has an important effect on the rest of the bankruptcy case, it may be heard in the Bankruptcy Court. For example, litigation over leases may be essential for a Chapter 11 reorganization proceeding, and may be tried by the Bankruptcy Court. As stated in Paragraph 1(a) above, the Bankruptcy Court has jurisdiction over civil proceedings arising under the Bankruptcy Code, or arising in or related to cases under the Bankruptcy Code. 28 U.S.C. §1334(b).

- C. Jury Trials. Pursuant to 28 U.S.C. §157(e) and Local Civil Rule 83.X.03 of the District Court of the District of South Carolina, the Bankruptcy Court in South Carolina may conduct jury trials. Rule 9015 of the Federal Rules of Bankruptcy Procedure provides that the Bankruptcy Court can conduct the jury trial only if all parties consent to the jury trial.

- D. Removal; Remand. Pursuant to 28 U.S.C. 1452(a), a party may remove any claim or cause of action in a civil action, other than a proceeding before the United States Tax Court or a civil action by a governmental unit to enforce its police or regulatory power, to the District Court if the District Court has jurisdiction over such claim or cause of action under 28 U.S.C. §1334. This provision allows the removal of matters to the District Court, and, by the reference under Local Civil Rule 83.X.01, to the Bankruptcy Court. However, pursuant to 28 U.S.C. §1452(b), the District Court or the Bankruptcy Court may remand the claim or cause of action on any equitable ground.

- E. Venue. The venue of a bankruptcy case, or of proceedings arising in or related to a bankruptcy case, is governed by 28 U.S.C. §1409. This statute governs where the bankruptcy case may be filed. Once the bankruptcy is filed in a proper venue, a matter in litigation may end up in that same venue, to be litigated in the Bankruptcy Court or District Court of that venue.
- F. Requirements for Employment of Professionals. If it is your client that has filed the bankruptcy and you are to continue in your representation, an Order must be obtained authorizing the trustee or debtor-in-possession to employ you under 11 U.S.C. §327. In conjunction with the application to authorize your employment, you will be required to submit an affidavit/statement under Rule 2014 of the Federal Rules of Bankruptcy Procedure, disclosing any and all connections you may have with any other party in the case. For a special counsel role (i.e., representation in a particular matter of litigation), you will not be disqualified if you or the firm has a connection with another party in the case, so long as it has no bearing on the matter you are handling. In order to be paid, you must apply to the Bankruptcy Court for authorization. Your fees and expenses must be presented in a required format, and the fees and expenses will be reviewed by the United States Trustee. You may receive payment only upon entry of an Order authorizing payment, unless, in the Chapter 11 case, the plan has been substantially consummated.

G. Change In Ownership of Claim. If your client files a Chapter 7 bankruptcy case, the bankruptcy estate will become the owner of the claim(s) against the other parties. 11 U.S.C. §541. A few exceptions exist, such as for a claim for damages suffered for a personal injury. However, in most cases, your client will no longer have control over the litigation of the claim, and the trustee will become the party holding the claim. In most cases, the trustee will request that the counsel previously handling the matter continue as trustee's counsel, but the trustee has the prerogative to change attorneys.

Note: We recently were able to settle a claim over the debtor's objection, which eliminated a class action suit against our client.

H. Avoidance of Judgment Liens. A judgment entered within ninety (90) days prior to the bankruptcy filing may be avoided as a preferential transfer under 11 U.S.C. §§547(b) and 550(a). The judgment will stand, insofar as it is an adjudication of issues therein; however, any lien on property created by entry of the judgment may be avoided.

Even if the judgment was obtained more than ninety (90) days prior to the bankruptcy filing, if the judgment attached against property as to which the full value is already encumbered by senior liens (e.g., mortgages and prior judgments), the judgment lien may be avoided under 11 U.S.C. §§506(a) and (d).

V. POSSIBLE TRUSTEE WAIVER OF ATTORNEY-CLIENT PRIVILEGE

- A. Even if the debtor is an individual, the bankruptcy trustee may have the right to waive the attorney-client privilege in civil matters, where such waiver will not expose the debtor to criminal prosecution. See, Anderson v. Vereen, et al. (In re Vereen), slip opinion, Case No. 96-78369-W, Adv. Pro. No. 98-80262-W (Bankr. D.S.C. 9/8/99) (trustee could waive the attorney-client privilege in an action to recover prepetition conveyances by the debtor), a copy of which decision is attached as Exhibit C to these materials.
- B. For a corporate debtor, the trustee's ability to waive the attorney-client privilege is well settled. See Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343, 105 S.Ct. 1986, 85 L.Ed. 2d 372 (1985).
- C. Where the trustee files action to recover assets on the basis that the assets were transferred with the intent to defraud, hinder or delay the debtor's creditors, and the defendants dispute the allegations, the defendants may be deemed to have placed the attorney's advice at issue and, thus, to have impliedly waived the attorney-client privilege. See Anderson v. Vereen, supra; In re Gibco, Inc., 185 F.R.D. 296 (D. Colo. 1997); and Small v. Hunt, 152 F.R.D. 509 (E.D.N.C. 1994).
- D. Communications between the attorney and client may also fall within the crime-fraud exception to the attorney-client privilege. "In order to invoke the crime-fraud exception, the trustee must make a prima facie case by demonstrating one or more

‘badges of fraud is present’.” Vereen; see also In re Andrews, 186 B.R. 219, 222 (Bankr. E.D.Va. 1995).

- E. In one case recently, the trustee asserted the right to waive the attorney-client privilege in a civil matter, to reach to communications by the attorney who had represented debtor and the debtor’s insurer in a personal injury case. In that case, the trustee brought action on behalf of the bankruptcy estate against the insurance company for the wrongful rejection of a settlement offer made by the plaintiff in the personal injury case. The insurance company had rejected a settlement offer of \$15,000.00, the limit of the debtor’s insurance coverage; judgment was entered against the debtor at trial in excess of \$100,000.00; and the debtor was placed involuntarily in a Chapter 7 bankruptcy case. The Bankruptcy Court ruled that the trustee could waive the attorney-client privilege, but the District Court reversed the Bankruptcy Court, and the matter was appealed to the Fourth Circuit Court of Appeals, at which time the parties settled the matter. Upon information and belief, at the trustee’s request, the Fourth Circuit vacated the lower court orders (or is going to vacate them), so as to eliminate potential precedence on the issue. (I am not at liberty to disclose the name of the case, but I have mentioned these facts to illustrate the potential issues that may arise in this area.)