

WHERE COLLECTION LAW MEETS BANKRUPTCY LAW

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Many in the debt collection area view bankruptcy as a stumbling block that interferes with their debt collection efforts because the bankruptcy court is typically a debtor-friendly forum. However, bankruptcy court does not always have to be feared. The Bankruptcy Code contains a patchwork of debtor-friendly and creditor-friendly provisions that, in the right case, can be useful for creditors. This article will discuss some of the more important aspects of bankruptcy law for those in the debt collection area.

I. OVERVIEW

Bankruptcy is a collective proceeding meant to level the playing field so that similarly-situated creditors are all treated in a similar fashion. However, each bankruptcy case must be analyzed in order to determine what a creditor can do to maximize its re-

covery or to limit its exposure to potential affirmative counterclaims by the estate in a particular case.

The Bankruptcy Code's protections are designed with the "honest, but unfortunate debtor" in mind. Therefore, if a debtor fails to comply with the requirements of the Bankruptcy Code or Rules or otherwise commits wrongful acts during a bankruptcy case, such malfeasance can constitute "cause" for a creditor to obtain relief from the automatic stay, to seek the appointment of a trustee, or to seek conversion or dismissal of a case.

II. KEEP THE END GOAL IN MIND

For creditors, payment is the overall goal in a collections case. In bankruptcy, payment should remain the creditor's ultimate goal. The unsecured or secured nature of a claim, along with the number and

amount of other similarly-situated claims in a particular class, can have a significant effect on an individual creditor's recovery. Because secured claims have the highest priority in bankruptcy, in most cases, unsecured claims generally receive less than full payment. Therefore, at the outset, creditors should carefully weigh the time and expense of pursuing a claim against the possible percentage of recovery they can ultimately expect to receive in a given case.

III. EARLY PLANNING AND POSITIONING ARE CRITICAL

Creditors should not wait until a bankruptcy case is filed in order to start analyzing how they will react to a bankruptcy filing by a litigation target. Instead, creditors should always consider the potential effect of a possible bankruptcy filing on their collection case and consider what steps they

can take before a filing to put them in a better position. Early planning and analysis will help, for example, if a collection target threatens bankruptcy in an attempt to extract concessions during litigation.

IV. TIMING OF THE BANKRUPTCY FILING

Many times a debtor will file a bankruptcy case in reaction to a ruling, a judgment or order of a court issued in litigation or arbitration. Sometimes, a bankruptcy case will be filed before a final judgment can be entered. This timing is to keep a creditor's claim "contingent," "unliquidated" and/or "disputed" in the bankruptcy case, requiring the creditor to timely file a proof of claim in order to preserve its claim.

Creditors and their attorneys should be aware that settlements reached in litigation can be affected by a later bankruptcy filing. For example, payments received from a debtor pursuant to a settlement agreement may be challenged as a "preference" if the debtor files a bankruptcy case within ninety (90) days after making the payment. Steps should be taken to avoid this unfortunate result.

V. APPLICABLE LAW IN A BANKRUPTCY CASE

Although state or federal law governs a creditor's substantive claim in a bankruptcy case, bankruptcy law has procedural requirements that, if not followed, can affect the allowability of the claim. For example, if a creditor fails to timely file a proof of claim when required, the creditor's claim by become time-barred by bankruptcy law, even though the underlying claim was asserted within the applicable statute of limitations.

VI. THE AUTOMATIC STAY

The automatic stay goes into effect immediately upon the filing of a petition for bankruptcy relief and is enforceable whether or not a creditor (or its attorney) has actual notice of the bankruptcy filing. Actions taken in violation of the automatic stay are either void or voidable (depending on the federal circuit the case is in) and can subject creditors and their attorneys to liability for damages.

It is important for businesses to have safeguards to prevent unintentional violations of the automatic stay by issuance of computer-generated demand letters. Any accounting/collection system should allow a "bankruptcy hold" to be placed on an account to prevent the inadvertent sending out of demand letters after a bankruptcy case is instituted to avoid stay violations.

Unless otherwise ordered by the Bankruptcy Court, the automatic stay against property of the estate continues until the debtor's property is no longer property of the estate. The automatic stay of all other actions against the debtor continues until the time the case is closed, the case is dismissed, or a discharge is granted or denied, whichever is earlier.

In a chapter 11 case, once a chapter 11 plan is confirmed, the automatic stay is no longer in effect, but is replaced by a discharge injunction under sections 524(a)(2) and 1141(d)(1)(A) of the Bankruptcy Code.

VII. OBTAINING RELIEF FROM THE AUTOMATIC STAY

Creditors can ask for relief from the automatic stay to pursue their claims in a non-bankruptcy forum. The grounds for relief from the automatic stay include "cause," including lack of adequate protection of an interest in property and, with respect to acts against property, that the debtor does not have any equity in the property and such property is not necessary to an effective reorganization.

The automatic stay is often vacated to allow non-bankruptcy litigation, such as tort litigation, to proceed in a more appropriate non-bankruptcy forum for litigating the issues. It is common for the automatic stay to be vacated to allow a plaintiff to pursue claims solely against the proceeds of a debtor's insurance policy only and not the debtor's assets.

VIII. SCHEDULES OF ASSETS AND LIABILITIES AND STATEMENTS OF FINANCIAL AFFAIRS

The Bankruptcy Code requires that a debtor list all of its assets and debts on its Schedules of Assets and Liabilities (the "Schedules") under penalty of perjury. Furthermore, debtors must fill out a detailed Statement of Financial Affairs (SOFA) under oath, that lists various historical information, including all pending lawsuits, all keepers of records, historical financial information and all potential preferential transfers. This information can be extremely helpful to collections attorneys for, among other things, determining the collectability of the creditor's claim in a given case.

On the Schedules, the debtor is permitted to state its value of a claim. Therefore, many times debtors schedule disputed litigation claims at \$0.00. As discussed above, if a creditor fails to timely file a proof of claim to controvert the scheduled amount of the claim, that creditor risks having its

claim valued at \$0.00 and will not receive distributions from the estate.

IX. BANKRUPTCY DISCOVERY AND TOOLS

Some of the useful tools available to creditors in a bankruptcy case include the Bankruptcy Code's requirement that a debtor attend a meeting of creditors where the debtor must testify under oath about the assets and debts set forth on its schedules. Creditors and their attorneys are allowed to attend and ask questions.

Rule 2004 of the Federal Rules of Bankruptcy Procedure allows a creditor to examine a debtor (or any other party in interest) under oath regarding the acts, conduct, property and financial condition of the debtor or any matter affecting the administration of the estate or the debtor's right to a discharge. Rule 2004 examinations are permissible "fishing expeditions" that are broader than the discovery permitted under state or federal procedural rules.

Creditors can challenge a debtor's right to a discharge or can object to the dischargeability of certain debts. This can put tremendous pressure on a debtor who is seeking a discharge.

Finally, if there is sufficient "cause," creditors can seek the appointment of a trustee or an examiner (in a chapter 11 case) to oust the debtor's current management or seek dismissal of a case (in any chapter), particularly if it was filed in "bad faith" or solely for use as a litigation tactic.

X. CONCLUSION

As long as creditors are educated about the bankruptcy process, the bankruptcy court does not have to be feared for collection matters. In fact, as discussed above, in some instances a bankruptcy filing by a debtor can actually be helpful to creditors because it gives them the ability to use powerful bankruptcy tools to aid them in their collection efforts.



Mr. Bolton is Board Certified in Business Bankruptcy Law by the American Board of Certification and holds a Certificate of Specialization from the Hawaii Supreme Court in Business Bankruptcy Law. Mr. Bolton currently serves as counsel in the Bankruptcy and Creditors' Rights department of Goodsill Anderson Quinn & Stifel in Honolulu, Hawaii.