When the Glass is Half-Filled with Emptiness: Some of the Issues Raised in Mediation When There is a Threat to File Bankruptcy [Part 2]

by Rebecca Callahan[1]

In Part 1 of this two-part article, we talked about the financial distress that is evident in just about every aspect of our daily lives and how insolvency and the threat of a bankruptcy filing or the actuality of a bankruptcy filing by one or more parties to a civil dispute have become frequent occurrences. We also looked at what an insolvent condition by one or more parties to a dispute might mean in terms of defining (or redefining) the problem and possible solutions so as to help the parties achieve the most that is available under the circumstances and, at the same time, minimize loss and control unnecessary expenditures of resources (namely time and money). The purpose of this article is to focus on the types of issues that might come up during the negotiation phase of a mediation when one party threatens to file bankruptcy – i.e., what is the bankruptcy backdrop for evaluating settlement and developing settlement options?

What is bankruptcy relief?

Bankruptcy is a legally declared inability or impairment of ability by an individual or entity to pay creditors. While there are "liquidating" and "reorganizing" bankruptcy options, the vast majority of cases filed are liquidations under Chapter 7 of the Bankruptcy Code. That is the assumed focus of this discussion. In the case of an entity, a Chapter 7 filing signals the close and cessation of business. In the case of an individual, a Chapter 7 filing signals the end of one financial life and the beginning of another (commonly referred to as the "fresh start").[1]

In the case of an individual who files Chapter 7, bankruptcy relief takes the form of a discharge of liability for pre-petition debts, which allows the debtor to allocate *future* earnings, income and gifts to *future* expenses, acquisitions and investments.[2] In exchange, however, the individual debtor surrenders his / her assets for administration and liquidation by a trustee, the proceeds of which are used to pay the allowed claims of pre-petition creditors.[3]

In the case of the business that files Chapter 7, there is no "debt discharge" relief.[4] However, liquidation of an entity in bankruptcy may relieve the company (and its owners) of the time and expense associated with the windup of the company's affairs, by transferring the marshaling, liquidation, payment and accounting responsibility to a bankruptcy trustee.

In the context of settlement discussions, the threat of a bankruptcy invites the parties to evaluate how they might fare in terms of their share of the estimated proceeds from liquidation after netting out payment of secured creditors' liens, costs of sale, the trustee's fee and possible priority claims (e.g., taxes, family support obligations). The treatment the debtor and creditor would receive in bankruptcy provides a logical / objective backdrop to both sides with respect to their best alternative to a negotiated agreement (BATNA), and may present their worst

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[1] Ms. Callahan is a mediator / arbitrator in private practice in Newport Beach, California. Ms. Callahan received her law degree from Boalt Hall at the University of California / Berkeley and her undergraduate degree from the University of Southern California. Ms. Callahan also has an LLM in Alternative Dispute Resolution from the Straus Institute at Pepperdine University School of Law.

alternative to a negotiated agreement (WATNA). For example, if for sake of discussion the parties assume that defendant is liable and that plaintiff will recover damages in the amount requested, that moves the dialogue to *collectability*. If the assumed "win" by the plaintiff will "kill the debtor" because it will force the closure of a business or a "surrender" of the individual's assets to a Chapter 7 Trustee, then the parties should consider ways in which the dispute can be resolved so as to avoid the bankruptcy scenario *if something better can be achieved outside of bankruptcy*. Generally, that equates to a cash payment of some kind and / or the giving of security for what was theretofore an unsecured claim.

Who may file for bankruptcy?

Just about anyone and anything can be a debtor in bankruptcy. 11 U.S.C. §§ 101(9), (13), (40) and (41); Gilliam v. Speier (In re KRSM Props., LLC), 318 B.R. 712 (9th Cir. BAP 2004). The key to eligibility for accessing the United States Bankruptcy Court is that the proposed debtor must reside or have a domicile, place of business or property in the United States. 11 U.S.C. § 109(a). So, for example, a Chinese company that owns golf courses in the United States can file or be put into bankruptcy in the United States. Likewise, a person who lives in California but whose primary assets are held in a Swiss bank account can file or be put into bankruptcy in the United States.

What this means in the context of mediation is that virtually anyone involved in an effort to mediate a dispute may be a prospective debtor in bankruptcy. And that, in turn, means that (a) the person or entity on the other side of the table may be a prospective *creditor* in that bankruptcy case, and (b) knowledge and understanding of bankruptcy law may be key to helping the parties assess the settlement value of the case.

While most bankruptcy cases are commenced voluntarily with the filing of a petition by the debtor,[5] creditors have the right and the power to *force* an insolvent person or entity into bankruptcy.[6] This is a very heavy club and is frequently threatened by (a) the ultra aggressive creditor intent on getting paid something, or (b) the creditor who believes it has been misled by the debtor and is done dealing with the debtor.

What type of "relief" is available to the debtor in bankruptcy?

Chapter 7 is the traditional liquidation or "straight" bankruptcy. It is by far the most common type of bankruptcy filing and represents the vast majority of bankruptcy cases filed in the United States. In all Chapter 7 cases, a trustee is appointed by the court to administer the debtor's assets for the benefits of unsecured creditors. The appointment process and the trustee's rights and duties after appointment are defined by statute. 11 U.S.C. §§ 701-704. As discussed below, once a petition is filed, the debtor's assets become property of the bankruptcy estate and are marshaled and sold by the trustee. The proceeds of sale are then distributed among creditors in the order of their statutory priority. 11 U.S.C. § 726.

For individuals, seeking relief under Chapter 7 is typically motivated by a desire to obtain a discharge from liability for all debts incurred prior to the date the bankruptcy petition was filed. 11 U.S.C. §727(a). What this means is that debtors who are individuals are able to exit

bankruptcy without the debt burdens they had prior to filing bankruptcy and can then dedicate their earnings to *current* expenses and after-acquired debt. It should be noted, however, that this "discharge relief" is available only once every 8 years. 11 U.S.C. § 727(a)(8).

Non-individuals such as corporations and other business entities are not eligible for debt discharge relief under Chapter 7. 11 U.S.C. § 727(a)(1). Nevertheless, there are still a very large number of business entities that filed Chapter 7 bankruptcy petitions. Such a filing usually involves the closing of the business and the surrender of the company's books and records to the bankruptcy trustee. The primary reason behind a Chapter 7 filing by a business is to allow the principals of the company to move on with their lives / careers without the distraction, time demands, expense and fiduciary responsibility associated with winding up the business and to lay those demands, expenses and responsibilities at the door of the bankruptcy trustee. Trustees are not required to administer estates where there are no assets, so the principals of the company may not receive the desired relief if the company does not enter bankruptcy with sufficient cash in the bank and other assets to make it worthwhile for a trustee to administer the case.

Chapter 11 is typically referred to as a "business reorganization" because it is most frequently accessed by incorporated businesses who want to continue operating or who want to liquidate in an orderly fashion (i.e., as a going concern). Although it is not often done because of the high transaction cost associated with this type of proceeding, individuals who are not engaged in business may file for relief under Chapter 11 and may reorganize their personal debts through a confirmed plan of reorganization. *Toibb v. Radloff*, 501 U.S. 157 (1991). For the individual whose debts exceed the Chapter 13 ceilings (discussed below), Chapter 11 is the only alternative if the debtor wants to remain in control of his / her assets and the disposition of same. In this regard, for the individual and business entity alike, the hallmark of Chapter 11 bankruptcy is that the debtor remains in control of the business operations and the administration and disposition of assets as a "debtor-in-possession." The rights and duties of the debtor-in-possession are statutorily defined and are basically the same as those ascribed to a bankruptcy trustee – meaning that the debtor-in-possession is a fiduciary who is charged with administering his / her / its estate for the benefit of creditors. 11 U.S.C. §§ 1107 and 1116.

The counter-balance to the debtor-in-possession is "the Committee." In Chapter 11 cases, a Committee may be formed of interested / representative creditor interests for the purpose of overseeing the debtor's reorganization efforts and communicating with the debtor regarding same. 11 U.S.C. §§ 1102-1103. The members of the Committee are fiduciaries for the creditor body they represent and are afforded standing to weigh in on each aspect of the debtor's case. The Committee is also allowed to engage professionals to advise and assist it and the expense of those professionals is charged to and must be paid by the debtor's estate (in addition to the expenses associated with the debtors attorneys and other professionals).

The whole idea behind filing a Chapter 11 petition is to confirm a *plan of reorganization* which restructures the terms and conditions of the debtor's pre-petition payment obligations to his / her / its creditors. This is a very technical process that is beyond the scope of these materials, except to say that the contents of the plan and the standards for confirming the plan are defined by statute. 11 U.S.C. §§ 1122-1124 (plan drafting provisions), § 1125 (plan disclosure and solicitation), § 1129 (plan confirmation standards) and § 1128 (plan confirmation hearing). If a

debtor confirms a plan under Chapter 11, he / she / it receives a "debt discharge" in the form of a novation – meaning that the debtor's pre-petition liabilities are superseded and replaced by the liabilities assumed under the plan. 11 U.S.C. § 1141. For entities, such debt discharge is conditioned upon the entity emerging from bankruptcy as an operating business. There is no debt discharge where the debtor confirms a liquidating plan.

Chapter 13 is typically referred to as the "wage earner" or "debt rehabilitation" chapter. Only individuals are eligible to file for relief under Chapter 13. Corporations, partnerships and other business entities cannot. Additionally, only individuals who meet certain statutory criteria may file petitions under Chapter 13: namely, they must have "regular income," such as wages or income from self-employment AND they must have liquidated, unsecured debts of less than $336,900 and liquidated, secured debts of less than $1,010,650. 11 U.S.C. § 109(e). Like Chapter 11 case, a debtor in a Chapter 13 case remains in control of his / her assets, 11 U.S.C. §§ 1303-1304, and confirms a plan of reorganization 11 U.S.C. §§ 1321-1326. Like a Chapter 7 case, a trustee is appointed to receive and distribute the payments the debtor makes under his / her plan. 11 U.S.C. § 1302. Unlike Chapter 7 or 11, a debtor in Chapter 13 does not receive a discharge unless and until he / she fully performs his / her obligations under the Chapter 13 plan. 11 U.S.C. § 1328.

Chapter 9 is a special set of statutory provisions dealing with "debts adjustment" proceedings for municipalities. 11 U.S.C. §§ 901-946.

Chapter 12 is a special set of statutory provision dealing with "debt adjustment" proceedings for family farmers and fishermen with regular annual income. 11 U.S.C. §§ 1201-1231.

Important Core Concept: the "bankruptcy estate"

A significant and frequently under appreciated aspect of bankruptcy is that *all assets* in which the debtor has *any* interest – wherever located – must be disclosed in the debtor's bankruptcy schedules even if the debtor believes it has zero value. This is because once a bankruptcy is filed, it is for the bankruptcy trustee and interested creditors to determine whether a particular asset has value, subject to the judicial oversight of the Bankruptcy Court. In this regard, the basic philosophy of bankruptcy is to provide a fair and equitable process whereby the rights of creditors vis-à-vis the debtor are adjudicated and paid to the extent that there are assets.

The commencement of a bankruptcy case operates to create an "estate." 11 U.S.C. § 541. What constitutes "property of the estate" is a key question because it delimits the pool of assets that will be available to satisfy creditors' claims. In general, all of the debtor's property as of the commencement of the bankruptcy case becomes property of the estate, except for certain assets expressly excluded by the Bankruptcy Code and certain assets that individual debtors are allowed to claim as exempt. Property of the estate is then marshaled, administered and eventually distributed for the benefit of creditors.

Section 541(a) of the Bankruptcy Code defines "property of the estate" quite broadly to include all of the debtor's legal or equitable interests in property, wherever located, including all real and personal property as of the date the bankruptcy petition is filed. A potential estate asset is not outside the scope of that definition merely because it is novel or contingent or because enjoyment must be postponed. *Segal v. Rochelle*, 382 U.S. 375 (1966). The estate succeeds only to the specific rights in property the debtor possessed as of the commencement of the case. Whether the debtor has an interest in property is determined by applicable nonbankruptcy law. *Butner v. United States*, 440 U.S. 48, 55 (1979); *United States v. Lawrence*, 189 F.3d 838 (9th Cir. 1999). The following are some examples of what constitutes "property of the estate":

- all of the debtor's real property interests, including fee interests, tenancies in common, joint tenancy, interests as a mortgagee or beneficiary under a deed of trust, interests under a land sale contract or lease of real property, any equity of redemption a debtor may have as a mortgagor or trustor under a deed of trust (11 U.S.C. § 541(a)(1));

- all of the debtor's personal property interests, including any interest the debtor has under a contract, property seized before commencement of the case, tangible property (e.g., goods, equipment, machinery, furniture, inventory, vehicles), intangible property interests (e.g., accounts, copyrights, patents, trademarks, choses in action, goodwill) (11 U.S.C. § 541(a)(1));

- all interests of the debtor and his / her spouse in community property, wherever located, as of the beginning of the case (11 U.S.C. § 541(a)(2));

- property that the debtor acquires or becomes entitled to acquire within 180 days after the filing of the bankruptcy petition by bequest, devise or inheritance; under a settlement agreement with a spouse or a divorce decree; or as a beneficiary under a life insurance policy (11 U.S.C. § 541(a)(5)); and

- proceeds, products, offspring, rents and profits from property of the estate whether received or accrued before or after the filing of the petition (11 U.S.C. § 541(a)(6)).

The threat or prospect of bankruptcy has the effect of putting the debtor's balance sheet on the table for discussion. Does the prospective debtor have "working assets"? If so, what will happen to those assets and the revenue they generate in a bankruptcy? What is the debtor doing with those assets and revenue now? If not, what does the other party hope to achieve by pursuing the litigation if the debtor has no working assets?

Important Core Concept: the "Automatic Stay" and Its Impact on Pending, Pre-petition Litigation

The filing of a bankruptcy petition operates automatically as a stay against a variety of acts affecting the debtor, property of the debtor and property of the estate without need for further action by the debtor or trustee, including but not limited to the commencement or continuation of a lawsuit to collect sums owed, to enforce any judgment against the debtor, or to repossess or foreclose on any property of the debtor. 11 U.S.C. § 362(a); *Far Out Productions, Inc. v. Oskar*, 247 F.3d 986 (9th Cir. 2001); *Contractors' State License Bd. V. Dunbar (In re Dunbar)*, 245 F.3d 1058 (9th Cir. 2001).

This stay is known as the "automatic stay," and constitutes fundamental Bankruptcy Code protection for both debtors (safeguarding against piecemeal dismemberment of the estate) and creditors (insuring equitable distribution). The stay is self-executing and becomes instantly effective the moment that the bankruptcy petition is filed. *In re Johns-Manville Corp.*, 57 B.R. 680 (Bankr. S.D.N.Y. 1986); *In re Schleier*, 290 B.R. 45 (Bankr. S.D.N.Y. 2003).

The automatic stay remains in effect unless or until the stay is lifted by court order under 11 U.S.C. § 362(d) or the case is closed or dismissed under 11 U.S.C. § 362(c). As to an individual debtor, the stay remains in effect until his / her discharge is granted or denied. 11 U.S.C. § 362(c).

Generally speaking, the automatic stay protects only the debtor. As such, when the debtor is one of several defendants in a pending lawsuit, the automatic stay applies only to the debtor. The action may proceed as to the remaining defendants. *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541 (5th Cir. 1983). A common problem that may arise when the debtor is one of several defendants concerns pending discovery. Although the litigation against the debtor is stayed, the stay does not prohibit a plaintiff from taking discovery from the debtor on matters relating to the claims against the other defendants. *Groner v. Miller (In re Miller)*, 262 B.R. 499 (9th Cir. BAP 2001).

While the automatic stay enjoins pre-petition litigation pending in the state or federal courts, it does not enjoin the commencement or prosecution of a lawsuit *in the bankruptcy court* where the debtor's case is pending. *Rein v. Providian Fin. Corp.*, 270 F.3d 895 (9th Cir. 2001); *Civic Center Square, Inc. v. Ford (In re Roxford Foods)*, 12 F.3d 875 (9th Cir. 1993).

The Bankruptcy Code provides that "relief" from stay may be granted upon the request of a party in interest and after notice and hearing. 11 U.S.C. § 362(d). Under Section 362(d), the Bankruptcy Court has wide latitude in crafting relief from stay. Such "relief" may take the form of termination of the stay, but the court also has the power to modify or condition the stay, as well as the power to annul the stay and grant relief retroactively. See, *National Environmental Waste Corp. v. City of Riverside (In re National Environmental Waste Corp.)*, 129 F.3d 1052 (9th Cir. 1997), cert denied, 524 U.S. 952 (1998); *Aheon v. Mellon Mortgage Co. (In re Aheon)*, 276 B.R. 233 (9th Cir. BAP 2002); *Palm v. Klapperman (In re Cady)*, 266 B.R. 172 (9th Cir. BAP 2001); *Fjeldsted v. Lien (In re Fjeldsted)*, 293 B.R. 12 (9th Cir. BAP 2003). (The grounds for seeking relief from stay are set forth in 11 U.S.C. § 362(d) and are beyond the scope of these materials.)

Any action taken in violation of the stay is *void ab initio* – not merely voidable. *Far Out Productions, Inc. v. Oskar*, 247 F.3d 986 (9th Cir. 2001); *Contractors' State License Bd. V. Dunbar (In re Dunbar)*, 245 F.3d 1058 (9th Cir. 2001). This is true whether or not the violation was willful. *Schwartz v. United States (In re Schwartz)*, 954 F.2d 569 (9th Cir. 1992); see also *Soares v. Brockton Credit Union (In re Soares)*, 107 F.3d 969 (1st Cir. 1997). Purely ministerial actions that do not affect the debtor's substantive rights – such as continuing the date of a foreclosure sale – will not violate the stay. *Mason-McDuffie Mortgage Corp. v. Peters (In re Peters)*, 101 F.3d 618 (9th Cir. 1996).

In the context of mediation where there is a threat or prospect of bankruptcy, this opens the door to discussing whether the automatic stay will apply to the dispute at hand. If so, this invites further discussion as to whether the Bankruptcy Court is likely to grant relief from stay to the other party to proceed with the litigation or whether the filing of a bankruptcy might prompt the initiation of litigation in the bankruptcy case, where the automatic stay does not apply. *Rein v. Providian Fin. Corp.*, 270 F.3d 895 (9th Cir. 2001); *Civic Center Square, Inc. v. Ford*, 12 F.3d 875 (9th Cir. 1993).

Common Negotiating Points: the Debtor Wants to Achieve "Debt Discharge"

Nondischargeable Claims. For individuals, the primary purpose for filing Chapter 7 bankruptcy is to obtain a "discharge" of prepetition debts. 11 U.S.C. § 727. Once obtained, the bankruptcy discharge operates as an injunction that permanently restrains the collection of a debtor or the enforcement of a judgment against the debtor. 11 U.S.C. § 524(a)(2); *Ruvacalba v. Munoz (In re Munoz)*, 287 B.R. 546 (9th Cir. BAP 2002). Although a discharge voids any judgment based upon a discharged debt, the discharge does not eradicate the underlying claim. The discharged claim continues to exist for purposes of supporting the creditor's right to proceed against the debtor's insurance company, co-signor, guarantor or other co-obligor.

In Chapter 7, only an individual is eligible to receive a discharge. 11 U.S.C. § 727(a)(1). Corporations, partnerships and other entities are not eligible to receive a discharge because, as a practical matter, they cease to operate when the case is filed. There is thus no reason for a "fresh start" and no reason to engage in the administrative aspects of entry of a discharge. A business entity may receive a discharge under Chapter 11, but only if it confirms a plan of reorganization where it emerges from bankruptcy as an operating entity. 11 U.S.C. § 1141.

Certain types of claims are excepted from discharge by express statutory provision. 11 U.S.C. § 523(a). The following are some of the more notable exceptions which apply without any type of legal proceeding of further court order:

- domestic support obligations (11 U.S.C. § 523(a)(5))
- student loan obligations (11 U.S.C. § 523(a)(8))
- obligations arising from the death or injury of another caused by operating a vehicle while intoxicated (11 U.S.C. § 523(a)(9))

- civil and criminal fines, penalties and forfeitures payable to and for the benefit of a governmental unit (11 U.S.C. § 523(a)(7))

- certain unsecured tax liabilities (11 U.S.C. § 523(a)(1))

For creditors whose claims against a debtor arise from fraud, defalcation while acting in a fiduciary capacity or intentional tort, *may* be excepted from discharge. 11 U.S.C. § 523(a)(2), (4) and (6). However, to qualify for exception from discharge, the creditor must file an adversary complaint - a new litigation proceeding in the Bankruptcy Court -- setting forth the facts and statutory grounds for seeking such exception. 11 U.S.C. § 523(a)(c). The creditor must then obtain a judgment by trial, summary judgment or default prove-up. It should be noted that the statute of limitations for filing a complaint under Section 523 is *very short*: 60 days after the first date set for the meeting of creditors under 11 U.S.C. § 341(a). FRBP 4007(c).

The significance of having one's debt declared to be nondischargeable under Section 523(a)(2), (4) or (6) is that it allows the creditor to seek enforcement of that judgment against the debtor's post-petition earnings and after acquired property and inheritances. Additionally, the judgment is a federal court judgment and is enforceable in any state without going through the sister-state judgment registration procedure.

In the context of mediating the litigated case, if one of the parties to the dispute threatens to file bankruptcy with the expectation of obtaining a discharge as to any potential liability arising from the lawsuit, that opens the door to discussing whether the type of claims that have been asserted in the litigation are eligible for exception from discharge. If so, that might make a cash-out offer more attractive to the other party. It might also invite discussion about how to structure a settlement so as to preserve nondischargeable claims if the settlement is not fully performed before a bankruptcy is filed.

Common Negotiating Points: the Creditor Wants to Insulate the Settlement from Attack as a Preferential or Fraudulent Transfer

Avoidance Actions. The Bankruptcy Code grants trustees (and Chapter 11 debtors-in-possession) the power to void or rescind certain prepetition transfers made by the debtor to third parties or, in the alternative, to recover the value of the property transferred. These so-called "avoiding powers" are codified in Bankruptcy Code Sections 544-550 and reflect the fundamental policy of bankruptcy law that the debtor's assets should be distributed ratably among the debtor's creditors; that no creditor be preferred by a pre-filing transfer or distribution. *Elliott v. Frontier Props. (In re Lewis F. Shurtleff, Inc.)*, 778 F.2d 1416 (9th Cir. 1985).

All of the avoiding powers are exercised by filing a complaint in the Bankruptcy Court, thus initiating an adversary proceeding under FRBP 7001. Filing and service of summons and complaint in an adversary proceeding is necessary for the Bankruptcy Court to obtain personal jurisdiction over the third-party transferee. If the trustee or debtor-in-possession is successful, the Bankruptcy Court will issue an order requiring the transferee to return the money or property transferred (or its value) to the estate.

The most commonly encountered avoidance actions are those seeking avoidance of a "preferential transfer" (11 U.S.C. § 547) and those seeking avoidance of "fraudulent transfers" (11 U.S.C. §§ 544(b) 548). A detailed discussion of these statutory causes of action and the defenses thereto is beyond the scope of these materials, except to identify the basic attributes of each:

- a **preference** is any payment or transfer of property by the debtor

  (1) to or for the benefit of a creditor

  (2) on account of an antecedent debt

  (3) made on or within 90 days before the filing of the petition or between 90 days and 1 year before the filing of the petition if the creditor was an "insider" of the debtor at the time of the transfer.[2]

  (4) at a time when the debtor was insolvent[3]

  (5) which allowed the creditor to receive more than it would have received in a Chapter 7 case had the transfer not been made and the creditor had received payment on its claim through the bankruptcy distribution process.

- a **Bankruptcy Code fraudulent transfer** is any payment or transfer of property by the debtor or any obligation incurred by the debtor during the one year period preceding the filing of the bankruptcy petition, voluntarily or involuntarily:

  (1) made or incurred with the actual intent to hinder, delay or defraud a creditor who either was a preexisting creditor or became one after the transfer was made (11 U.S.C. § 548(a)(1)(A)), or

  (2) made or incurred with the debtor receiving less than a reasonably equivalent value in exchange for such transfer or obligation (11 U.S.C. § 548(a)(1)(B)(i), AND

    (a) the debtor 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 (11 U.S.C. § 548(a)(1)(B)(ii)(I));

[2] The term "insider" is defined in 11 U.S.C. § 101(31).

[3] "Insolvency" for this purpose essentially means "balance sheet insolvency." (E.g., the sum of the debtor's debts is greater than the debtor's assets at a fair valuation.) There is a presumption that the debtor was insolvent during the 90-day period preceding the bankruptcy filing, which presumption is rebuttable. 11 U.S.C. § 547(f).

(b) the debtor 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 (11 U.S.C. § 548(a)(1)(B)(ii)(II);

(c) the debtor 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 (11 U.S.C. § 548(a)(1)(B)(ii)(III), or

(d) the debtor made the transfer to of for the benefit of an insider, or incurred the obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business (11 U.S.C. § 548(a)(1)(B)(ii)(IV).

- a **State Law fraudulent transfer** is one that is voidable under applicable law by a creditor holding an unsecured claim. 11 U.S.C. § 544(b)(1). This subsection does not create any independent avoidance power. It merely recognizes the right of an actual creditor to avoid a transfer or obligation under any applicable nonbankruptcy law and confers standing on the trustee or debtor-in-possession to initiate and prosecute such a claim. For example, this section allows a trustee or debtor-in-possession to assert, for the benefit of the estate, a creditor's rights under the Uniform Fraudulent Transfer Act as adopted by California (CC §§ 3439-3439.12). See, *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*, 34 F.3d 800 (9th Cir. 1994). The existence of such a cause of action, however, depends on whether a creditor existing at the time the transfers were made still had a viable claim against the debtor at the time the bankruptcy petition was filed. If no such creditor exists, then the trustee or debtor-in-possession is without power to act under Section 544(b). The general significance here is where the transfer occurred more than 1 year before the filing of the bankruptcy. The only way to avoid such a transfer and bring the property back into the estate is to be able to assert a claim under the state fraudulent transfer law which generally has a longer statute of limitations period.

In the context of mediating the litigated case, if one of the parties to the dispute is insolvent or has threatened bankruptcy, that could affect the financial dynamics of the settlement negotiations. This circumstance may invite discussion as to how the deal might be structured so as to insulate the settlement from avoidance attack. It might also alter the parties' negotiating objectives. For example, in anticipation of a post-settlement bankruptcy, one party might demand more money up front, insist upon a shorter installment period, or structure the settlement in the form of a stipulated judgment with a forbearance agreement so long as certain terms and conditions are met.

Common Negotiating Points: Redefining What Constitutes a "Good" Outcome

WATNA. One way to evaluate a settlement proposal is to consider the *best alternative* to that proposal (BATNA). In the context of the litigated dispute, BATNA is proceeding with the judicial proceedings to judgment and evaluating the likelihood of prevailing / defending on some or all claims. Introducing one (or more) party's insolvency / potential bankruptcy forces all parties to consider their *worst alternative* to a pending settlement proposal (WATNA).

Theoretically, bankruptcy is intended to regulate and balance the interests of debtors versus their creditors. However, in practice, bankruptcy exacts a toll on *all* parties. The process itself is expensive because, where there are assets to be administered, the bankruptcy trustee's fees and the attorney's fees and costs incurred in administering the bankruptcy estate are given *preferred treatment* under the Bankruptcy Code, allowing them to be paid in full before the allowed claims of unsecured creditors. This is a *huge issue* that needs to be considered if bankruptcy is truly on the horizon for any party to a civil dispute and asks the following question: Assuming that a bankruptcy trustee acts diligently and takes the most efficient and economical course of action in marshaling and liquidating the debtor's assets:

- what is the estimated cost of the bankruptcy trustee's activities,
- what is the estimated net recovery to the debtor's estate for distribution to unsecured creditors, and
- what is the litigant creditor's estimated pro rata share of that "pot" taking into consideration other creditors' claims against the debtor?

Bankruptcy is not always a "club". A threatened bankruptcy filing by a defendant / potential debtor is not always a "club" that the debtor holds over the creditor's head. There are certain rights and benefits that a creditor gains in bankruptcy – especially when dealing with dishonest debtors or debtors who have exhibited poor judgment in the management of their business or affairs. In some cases, a creditor might prefer working with a Chapter 7 Trustee even though it would mean doing so in a "fire sale" liquidation scenario.

On the flip side, where the plaintiff is insolvent and contemplating bankruptcy, the defendant may perceive an opportunity to "settle cheap" once a bankruptcy trustee is in control of the plaintiff's litigation.

Concluding Remarks

Opportunity. Insolvency and the threat of bankruptcy offers up an opportunity for the parties to participate in a constructive exchange of information. Most importantly, that circumstance creates an opportunity for candor and communication about a subject that is slightly off topic (i.e., not focused on the merits or demerits of the dispute) and is relevant to both parties, especially if the objective of the litigation is to achieve a recovery of money or property from the other side. In those circumstances, the prospect of insolvency or threat of bankruptcy challenges the parties to think more broadly so as to come up with a solution that cuts their losses and does the best they can with a bad situation.

Insolvency analysis takes a hard look at the insolvent situation and asks: How did this happen? Is it a cash flow problem? Is it a balance sheet problem? How bad is it? What mistakes were made? Can those mistakes be corrected? Is it a matter of cutting costs? Is it a matter of infusing new capital? Are there any assets that can be sold or refinanced? For the operating business, two questions must be asked are the business can be saved and whether it is worth saving. For the individual, consideration should be given to his / her future prospects, especially the possibility of inheritance.

Insolvency is a "reality factor" that frequently trumps / overwhelms the dispute.

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[1] In this regard, it has been said that a fundamental purpose of the bankruptcy system is to "relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." *Educ. Credit Mgmt. Corp. v. Coleman (In re Coleman)*, ___ F.3d ___, ___ (9th Cir. 2009).

[2] 11 U.S.C. §§ 727(a) and 524(a).

[3] 11 U.S.C. §§ 541(a) and 704.

[4] 11 U.S.C. § 727(a)(1).

[5] 11 U.S.C. § 301.

[6] A single creditor holding a claim for at least $13,475 that is not contingent or disputed can file an involuntary petition if the proposed debtor has fewer than 12 creditors. 11 U.S.C. § 303(b)(2). Three creditors holding claims that total in the aggregate $13,475 that are not contingent or dispute can file an involuntary petition if the proposed debtor has 12 or more creditors. 11 U.S.C. § 303(b)(1). If the proposed debtor is a partnership, the entity can be forced into bankruptcy by fewer than all of the general partnership. 11 U.S.C. § 303(b)(3).