AMERICAN BANKRUPTCY INSTITUTE

2017 Northeast Consumer Forum

Disincorporation: Pre-Petition Planning Versus a Harbinger for Disaster

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2017

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"The Debtor's Perspective for a successful Chapter 13 involving a Disincorporation"
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<u>Introduction:</u>

The following sets forth the intricate set of considerations the Debtor's Attorney must undertake prior to recommending that one's client implement the process referred to as "Disincorporation" as discussed by this group within the context of the program materials prepared by the Panelists and presented to the program attendees. The process is not simple and is fraught with multiple areas of potential creditor allegations that the Debtor is committing all kinds of unfair or fraudulent acts which may very well be raised against the Debtor in the Chapter 13 proceeding. A discussion of the implementation of this process relative to a Chapter 13 case and the proposed plan which must conform to the requirements needed for Confirmation are set forth below.

<u>I. Preliminary Business and Tax Considerations</u>:

a. Is the business entity organization no longer needed in light of the financial status of both the business and the equity holders?

One must first ask: Is the entity solvent or insolvent and what does the Profit and Loss Statements s**h**ow relative to trending earnings? Further, what is the nature of the debts? If the assets are substantially liened by creditors and the value of the property is more than the debts secured then Disincorporation is really not desirable because the assets can be sold or the debt probably refinanced to more favorable terms as long as the business is profitable. Should the business income not be profitable and that financial status doesn't appear to be changing in the near term and no amount of reorganization is likely to redeem the cash flow, then it is reasonable to conclude that maybe the protection of the corporation or LLC is no longer of paramount concern. If the business appears to be in severe decline then one should consider closing the business. However, before doing so, one should consider sale of assets and dissolution of the entity with the remaining debt to be dealt with by the equity holder which may include a personal Bankruptcy.

However, if the assets of the entity are valuable to the equity holder or desirable so that one would want to retain possession of the same, then dissolving the entity will not allow the equity holder to retain the assets since liquidation is a required act after dissolution and winding up are completed. Accordingly, if asset retention is the goal then doing a Dissolution is not the answer since filing Articles of Dissolution create a statutorily imposed Fiduciary Relationship between the creditors and the equity holder(s) to follow the statutory process and liquidate assets to pay debt before any equity can be retained. Further, if assets are subject to unavoidable liens either under State laws or Bankruptcy laws, then the secured creditors are entitled to appropriate collateral and exercise rights of sale to liquidate assets in order to pay the debt owed. It would not make sense to dissolve the entity if the business is solvent since the remaining equity after debt is paid belongs to the owners. Once reduced to cash and distributions are made the remaining creditors of the equity holder can reach those funds, to the extent they are not exempt under Non-Bankruptcy Laws, thus exposing the return on investment earned from the business enterprise to the claims of personal creditors.

Option: File a Chapter 7 Bankruptcy for the entity thus invoking the Automatic Stay of Section 362(a) and allow the Trustee to liquidate the business prior to filing Articles or Notice of Dissolution, but only if equity will be returned to the owners as Equity Holders by the Court.

b. Is the equity holder solvent or insolvent and does he/she need bankruptcy protection? If the equity holder is in need of bankruptcy protection then does one file the bankruptcy still owning and operating the business or close it before filing the case?

If the equity holder is in need of bankruptcy protection then one must immediately assess which Chapter is applicable and whether or not the ownership and continued operation of the business is possible, desirable and/or practicable. In other words, if the business can't be saved and the decision has been made to close it then filing a Chapter 7 for the Individual and listing the business equity ownership as an asset may very well allow the Chapter 7 Trustee to reach the assets of the entity by stepping into the shoes of the equity holder thus selling the assets if money will be available for unsecured claims. On the other hand, if the entity is insolvent and no asset value exists for the Chapter 7 Trustee, then in all likelihood the asset of "equity ownership" will be abandoned and creditors of the entity can move against the assets for payment of the debts owed. In this instance, if the goal of the Individual equity holder is to protect the assets of the Entity then filing an Individual Chapter 7 is not a good idea. This leads to consideration of the Chapter 13 option which is the subject of this program presentation.

When considering whether or not to file a Chapter 13 for the equity holder one must first decide if the business is to remain in operation and it will be the source of the plan funding in some significant measure or not. If the business income generated from the entity as an ongoing concern is necessary to fund the plan then the Chapter 13 is filed without a prior "Disincorporation" or filed without proposing a "Disincorporation" as one of the plan terms being subject to confirmation by the court. However, if retaining particular assets of the Entity is the main focus of the Chapter 13 Debtor and keeping those assets in the ownership of the Entity while the Individual performs under a Chapter 13 Plan one can't assure that the creditors of the Entity won't act upon the assets of the business if it is not faithfully paying its debts. Under these circumstances one should consider "Disincorporation" prior to filing the Chapter 13 Case. One must here note that the Co-Debtor Stay of Section 1301 of Chapter 13 won't protect the Entity or the assets owned by the Entity during the Chapter 13 term. How then does one "Disincorporate" prior to filing the Chapter 13 and protect the Entity assets from collection claims of the business creditors without creating a Fraudulent Transfer possibility?

c. What must one consider prior to the transfer of the Entity assets to the equity holder prior to filing Chapter 13 Case?

At this juncture of the process time will be of the essence and the need to protect the business assets will be of prime concern if creditor collection efforts are in progress against the Entity. Planning to transfer Entity assets to the Individual equity holder at this time raises the concern of possibly committing Fraudulent Transfers relative to the Entity and its creditors. A transfer from the LLC/Corporate Entity to the equity holder(s) for no reasonable equivalent value could indeed implicate the possibility of a challenge to the transfer(s). However, in most instances the equity holders have already co-signed or guaranteed the commercial loan obligations so the Individual as transferee is obligated to pay the loans as well as is the transferor. If the debt was not guaranteed by the Individual transferee then the transferee should be required to assume the debts which are secured by the property to be transferred as a personal liability and the debt assumed should have a value equal to or greater than the value of the property to be transferred. Further, one must consider whether or not the Individual equity holder, as a future Chapter 13 Debtor, has acted in good faith in filing the case and whether he can propose a plan in good faith to conform to Section 1325 Confirmation of Plan requirements of Chapter 13? If the creditors of the Entity get notice of the transfer and commence an action against the transferor and transferee under State Laws then one must anticipate that the Debtor will be dealing with this claim in the Chapter 13 as a disputed, unliquidated and non-contingent claim, once the Chapter 13 case is filed, whether or not the action is commenced prior to the Chapter13 case is filed. It certainly makes a difference if the state law action is commenced by secured or unsecured creditors and to what extent the property transferred has value relative to the debts owed and/or secured by the property to be transferred.

d. Income Tax Considerations.

Prior to making a transfer of assets to the Individual equity holder one must first consult a tax advisor to determine if there will be any income tax consequences to be realized and ultimately recognized by either the Entity and/or the Individual. If the Debtor as equity holder is the actual tax payer and not the Entity then any tax owed may be a claim made in the Chapter 13 case by the Government which will have to be paid in the Plan if not paid prior to filing, unless the tax claim is not treated as a Section 1305 claim by the IRS or other taxing authority. If the tax claim is significant then the Debtor must be able to pay the Priority tax claim in five years in the Plan. If the cost basis of the transferred property is low, even after recapture, then the tax bill may be non-existent or very low. However, in any situation, where one considers the strategy of "Disincorporation" and the transfer of Entity assets to the Individual equity holder one must also consider the immediate tax consequences of doing the proposed transfers.

II. Chapter 13 Considerations:

a. Section 109 *Who may be a debtor* subpart (e) debt limitations.

This section of Chapter 13 limits the amount of debt which a debtor may have when filing the case. The debts, whether secured or unsecured, are referred to and calculated as non-contingent and liquidated, whether or not they are disputed. The monetary cap for Secured Debts is $1,184,200.00 and the cap for the unsecured claims, including priority claims is $394,725.00 as of April 2017. When one makes a transfer of an asset those assets may be subject to liens and as such the lien amount counts in the debt limitation calculus as long as the debtor has personal liability on the claim secured by the lien against the assets transferred. The word "claim" is a defined term in Section 101(5) of Title 11 and it is very broad, indeed. However, not all "claims" are "debts" owed by the Debtor for Section 109 purposes. The word "debt" is also a defined term under Section 101(12) which simply states that "debt" *means liability on a claim.* So, before one transfers property to the Individual prior to filing the case one must know if the debtor has personal liability recourse on the claim to the holder of the same. If the Debtor co-signed or guaranteed the "claim" but did not convey the title of the property to secure the debt then a creditor can still argue that the Debtor is indeed liable on the "claim" as guarantor. If this is accepted by the court then the debt must be counted in the calculus when one determines the debt limitations of the case; but is the "debt" a secured claim or an unsecured claim for purposes of Section 109? One would argue the issue in the best interests of the Debtor depending upon the mathematical risks inherent in the case relative to exceeding debt limits for one class of claims or the other. Obviously, if the claim is secured and the debt limits are not exceeded then that claim must be treated in the plan accordingly while maintaining feasibility. Should the claim be deemed "unsecured" and the debt limitations are not exceeded then the Plan must treat the claim in some fashion in order to assure that the creditor is bound by the plan when confirmed and the unpaid debt will be discharged under Section 1328(a) or (b).

b. Assets become property of the Estate under Section 1306.

Once the Debtor acquires the title to assets transferred they all become property of the Estate unless exempted under applicable laws. If the assets are in the Estate and not exempted then the value of those assets become relevant to calculating the plan payment relative to holders of allowed unsecured claims under Section 1325(a)(4). Although the Debtor retains possession of the assets during the Chapter 13 case under Section 1306(b) the value of the same are used to determine the Chapter 7 Liquidation Distribution Equivalent and that amount must be paid to satisfy Priority Claims first and thereafter allowed unsecured claims, to the extent funds remain after paying Priority Claims. If the Debtor retains the property and chooses not to use it to pay claims under Section 1322(b)(8) or vest title of the property to a third person under 1322(b)(9), then the Debtor may very well have to offer Adequate Protection to the holder of the claim under Section 361 or Section 1326(a). Finally, once the assets are in the Estate further use, sale or lease of the same is subject to Section 363 together with the added requirements of Section 1304 if the is debtor engaged in business. Finally, once the plan is confirmed and it contains a vesting upon confirmation provision, Section 1327 will operate to vest title back into the Debtor free and clear of those claims and interests of creditors provided for by the Plan hence eliminating the creditor's adverse interest, pending consummation of the plan.

c. Proposing a Plan to meet confirmation Requirements.

One must review the plan provision options set forth under *Section 1322 Contents of plan* for the both the mandatory and permissive plan provisions which pertain to the specific types of property obtained from the Entity by the Individual equity holder prior to the filing of the case. The only mandatory plan provision which may be a limiting factor is sub-part (3) should the Debtor choose to classify claims relative to the permissive treatments afforded under Section 1322(b), in particular sub-parts (2) modification of rights of holders of claims; (3) curing or waiver of defaults; (5) curing a default along with reinstatement and deceleration of a long term debt; (7), assumption, rejection or assignment of any lease or executory contract related to said property; (8) using the property to pay a claim in lieu of using cash; and (9) to provide for the vesting of title of the property in a third person or entity.

In order to have the plan confirmed the provisions of Section 1325 must also be met relative to the property obtained. Again, if any of the property is non-exempt then sub-part (a)(4) must be complied with as discussed above in (b) and all of the provisions of (a)(5) must pertain if the property secures a claim being provided for in the plan. First and foremost, the holder of the secured claim must accept the plan if the treatment is not provided for pursuant to sub-part (B) by making deferred installment payments for the full amount of the allowed secured claim or under (C) if the property is being surrendered to the holder of the claim. Finally, any plan payment offered must be feasible and be made in good faith.

d. Will Section 506(a) Determination of Secured Status or Section 522(f) Judicial Lien Avoidance be applicable?

Once the asset is transferred to the equity holder subject to any form of lien the Debtor must consider whether or not the lien is subject to stripping, bifurcation or avoidance, as the case may be. Generally, these reorganizational tools of a Chapter 13 case are important powers which the Debtor has in order to reorganize debt and maintain property ownership at the lowest buy-back costs. Since the assets subject to the liens are not the Debtor's principal residence then Section 1322(b) applies and the anti-modification prohibition is not applicable so a Section 506(a) motion is entirely possible. However, the resulting claims must be dealt with in the plan in no more than a five year period and the resulting unsecured portions of the secured claims will be added to the total unsecured debt limits of Section 109(e), as discussed above. The same will be true for any secured claim that is converted into an unsecured claim in accordance with Section 522(f) judicial lien avoidance, assuming the asset acquired is exempt and the judicial lien impairs such an exemption. With Section 522(f) motions, the Judicial Liens sought to be avoided may not be possible if the lien was fixed against the property against the Entity's interest prior to acquisition by the Debtor so avoiding the lien when the equity holder obtains title may not be possible.

e. If the Debtor is engaged in business and new credit is necessary to refinance secured debt which survives the filing of the Chapter 13, will Section 364 Obtaining Credit be implicated?

Depending upon the nature of the lien which attaches to the property when transferred to the Debtor and assuming further that the reorganization powers under the Code do not provide the Debtor with sufficient debt relief, then obtaining new credit by the Individual Debtor may be an option. If the Entity was unable to obtain credit to refinance the secured claims encumbering title to the assets to be retained then maybe the Debtor would be in a better position to obtain credit while a Debtor in a Chapter 13 case. However, one must recognize that qualifying for non-consumer credit for a debtor engaged in business who presents a healthy cash flow projection for the business operations is a taunting task indeed. Notwithstanding this challenge, depending upon the nature and amount of debt being treated in the Plan it may be possible to obtain credit as a 13 Debtor or simply wait until the case is closed and the discharge enters and then consider refinancing debt that survives the Chapter 13 process.

f. Executory Contracts and Unexpired Leases: Can these obligations be likewise transferred to the Equity Holder(s) as part of the Disincorporation?

When considering doing a "Disincorporation" relative to corporate property subject to liens granted by the Entity one must also look to any Executory Contracts and/or Unexpired Leases to determine if these are to be construed as assets or merely as liabilities to be rejected and later discharged. If the leases or contracts are valuable assets of the Entity and disincorporation is a viable option relative to hard assets then one should likewise consider if the contracts and leases are assignable to the Equity Holder and they too should become part of the Chapter 13 Estate and treated in the Plan accordingly. Assuming the Individual Debtor is engaged in business and Section 1304 applies and the leases and contracts are indeed assignable and would be valuable to the Chapter 13 Debtor's Estate, whether or not the Individual Debtor has personally guaranteed the same, then Section 365 applies to Chapter 13 by direct reference in Section 1322(b) (7) (Contents of plan) so assignment should be considered. This section provides that a plan can include an assignment (or rejection) of contracts or leases which were not previously rejected in accordance with provisions of Section 365; the debtor can assume the same as part of the Plan structure and as a source of funding, if applicable.

g. Proposing a Disincorporation as part of a Chapter 13 Case vs. Disincorporation prior to filing.

Ultimately, when considering a "Disincorporation" the attorney must decide whether to make the transfer of assets to the equity holder prior to or after the Chapter 13 case is to be filed. One can safely argue that most disincorporation efforts are done in preparation of and prior to the Individual filing the Chapter 13 case; however, this is not a prerequisite and not always the best course of action. Recognizing that the Automatic Stay protects all property of the Debtor and of the Estate whenever it is acquired, it may be preferable for the Debtor to acquire the assets after the Chapter 13 is filed, assuming Corporate Business creditors are not engaged in aggressive collection efforts at the time the Chapter 13 is filed. In other words, if the Individual is facing collection efforts by one's personal creditors and any newly acquired assets would be at risk of being charged with liens, attachments, charging or restraining orders prohibiting any transfers, then one may want to file the Chapter 13 immediately to stop all collection efforts against the Debtor and thereafter acquire the business assets (real or personal property, leases and/or contracts) to bring them into the Estate immediately being protected by the Automatic Stay. Should this approach be taken then the Debtor should note the proposed post-petition acquisition of assets in the plan as a term which proposes adequate means by which to implement, fund, and consummate the plan; by doing so that the plan as filed would be deemed feasible and proposed in good faith. Further, once the assets are acquired by the Debtor the Plan may propose certain usea, sale or lease of the property to make money for the Estate so the requirement of Section 363 would pertain, as would Section 364 Obtaining Credit, should the debtor need to use the assets as collateral for Chapter 13 Debtor financing. Finally, should a transfer be contemplated post-petition then Section 1322(9) certainly applies to the case and title to the newly acquired assets can vest in another entity at time of confirmation or sometime later in accordance with the Confirmation Order entered in the case.

III. Post-Petition and Pre-Discharge Considerations.

Assuming the Debtor's efforts at Disincorporation are successful and the Chapter 13 Plan is confirmed then the debtor must now consider what to do with the Corporate/LLC entity which still exists but is now insolvent and no longer doing business; clearly, all creditor claims remain active against the Entity since the Co-Debtor stay does not pertain to non-consumer debts. The creditors of the Entity can still pursue the Entity in civil court to reduce claims to judgments and the Entity is still subject to State Court actions claiming Fraudulent Transfer Avoidance which can be pursued contemporaneously with the Chapter 13 process, either prior to or after confirmation, with consent of the Bankruptcy Court. Until and unless these claims are quelled the possibility of completing the payments of the confirmed Plan and receiving a discharge are tenuous at best, especially if the Bankruptcy Court allows for relief from Automatic Stay to include the Debtor as a transferee/Defendant in the civil action pending in another court. However, assuming the plan has been confirmed prior to commencement of the state court actions one can argue that Section 1327 applies to all creditors of the Debtor including those creditors who still have claims against the Entity; one would argue that all creditors are bound by the plan, as confirmed, whether or not the claim of the creditor is provided for by the Plan and regardless if the creditor accepted or rejected the plan. Further, unless provided otherwise in the plan or Order Confirming the Plan, the confirmation of the plan vests title of all Estate Property back into the Debtor and it vests free and clear of all claims and interests of creditors provided for by the Plan. Based upon this Code Section, it becomes clear that getting the Plan confirmed as soon as possible is of paramount importance; in this regard Section 1324 is very important and one must be able to proceed to confirmation as soon as practicable. Confirmation can't take place earlier than 20 days after the Section 341 Hearing Date, without court permission but not later than 45 days from said hearing date. The quicker the debtor moves to confirmation the better so to be able to implicate the protections of Section 1327(a-c) as discussed above.

In the case where creditor action is commenced against the Entity prior to the confirmation of the plan (or even prior to filing) the Debtor risks not having the Plan confirmed prior to judgment being entered in the state court action; one should expect that creditors will come to Bankruptcy Court to file motions to lift the stay, seek a dismissal of the case, or oppose confirmation under Section 1325(a)(3) and (7) arguing that neither the plan nor the case have been proposed and filed in Good Faith. Section 1307 Dismissal motions may be filed charging that under sub-section (c) the case should be dismissed for cause with said cause being the same grounds applicable to the Fraudulent Conveyance Action as being applicable to a motion under Section 1307(c) or even relevant to a later hearing in opposition to confirmation of the plan under Section 1325(a).

Finally, assuming that the Debtor obtains confirmation and obtains a Discharge and all is quiet with issues related to the insolvent Entity then it is time to consider filing articles of dissolution for the Entity which is no longer needed. At this point in time the dissolution proceeding under State Law should be rather routine and completed without much effort; the assets of the entity have all been transferred to the Individual Debtor and claims have been paid or otherwise dealt with in the Plan as confirmed. At this point in time the corporate entity is now an empty shell ready to be returned to Incorporeal Cyber Space from which it came, taking with it any remaining unsatisfied debts.

iv. Considerations prior to case being closed:

Once the plan payments are finished and the Trustee is busy going about preparing and filing the Final Report and Motion to Close Case, one must consider the possible effects of Section 1306(a)(1) and the chance that after acquired assets come into the Estate prior to the case being closed, dismissed or converted. One possible source of this happening relative to the context of the instant discussion is within the context of the dissolution of the Entity which just underwent "Disincorporation". A careful consideration of the prospect that the Debtor, as the equity holder of the Entity, will obtain the equity value of any corporate asset remaining after dissolution is completed, assuming no creditor claims remain to be paid, must be undertaken ab-initio. Assuming the Chapter 13 Plan was successful in dealing with all creditor claims of the Disincorporated Entity and the dissolution was successful but some assets remain in the name of the Entity which have significant value, then in that event, those assets become property of the Debtor's Estate and must be considered as being available to pay creditor claims, if in fact some creditors did not receive full payment. In the event this rare occurrence arises prior to the closing of the case then the Trustee or a holder of an allowed unsecured claim can motion the court under Section 1329(a-c) for a modification of the confirmed plan to provide for additional payments to those creditors not receiving 100 percent payment. The ever vigilant Debtor's Attorney always bears in mind that the Estate remains open until the case is closed, dismissed or converted, whichever occurs first, so having a full understanding of all assets of the Entity is a must prior to undertaking the process of "Disincorporation". Assets such as rebates, refunds, credits of all kinds, including tax credits, loss carryovers, tax refunds allowed to the Debtor resulting from any business expense allowance or even if the Entity had claims pending against third parties and those matters ultimately bring in funds which may have been earlier deemed speculative or unlikely, these monies pass to the debtor and come into the Estate for Chapter 13 purposes. A word to the wise, prior to engaging in the "Disincorporation" one should do a Chapter 7 Liquidation Analysis of the Entity as part of a careful charting of the course for the Chapter 13 case; one must know in advance with certainty all of the assets of the Entity, whether the Disincorporation is to take place prior to or after the filing of the Chapter 13 case.

Conclusion:

Based upon the discussion above one must appreciate that the process of "Disincorporation" as being replete with risks which must be identified and managed in the context of how each risk impacts the chance of obtaining a confirmed plan of repayment under Chapter 13. All of the matters discussed herein must be identified and carefully considered prior to undertaking either the Disincorporation or the filing of the Chapter 13 case. Further, if the feasibility of the plan is in doubt due to the limitations imposed on the Chapter 13 case by Congress then the Attorney may indeed have to consider seriously the same process of Disincorporation but implicated within the parameters of an Individual Chapter 11 Case. In this situation where the Debtor in Possession is a natural person and not an Entity the obstacle of the modified Absolute Priority Rule may be the prime impediment to obtaining a discharge for the debtor in a Chapter 11 case. However, whether the evolving option of using "Disincorporation" within the context of a bankruptcy case, whether it be Chapter 7, 11, or 13, one must assume that the creditors affected by this maneuver will resist the attempt as an end-run implemented by the Disincorporation of the Entity and be ready to defend all the arguments which can be thrown your client's way, both in State Court and in the Bankruptcy Court. A word to the wise bankruptcy practitioner, ask yourself: "How will I be able to get paid for all of this work?".

Good luck with your future endeavors at "Disincorporation".

Disincorporation: Pre-Petition Planning Versus a Harbinger for Disaster[1]

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[1] These written materials were substantially prepared by the non-judicial members of the Panel, but with critical input from the entirety of the Panel members on the substance of the topic area and issues discussed. With respect to the valuable contributions of Bankruptcy Judge Finkle, as in all instances with judicial officers, any opinions, remarks, or other thoughts expressed in these materials should not, and cannot, be deemed formal or adopted positions of Bankruptcy Judge Finkle or of the United States Bankruptcy Court for the District of Rhode Island.

Introduction

This paper discusses the growing practice of the prepetition transfer of business assets to insiders to allow for an individual filing, and the resulting issues for debtors, creditors, the bankruptcy estate, and the Bankruptcy Courts. Is it fraud *per se*, or is it a creative way to get your individual client and their business assets into one case? Perhaps it depends on the end result or the perspectives of the various parties, such that what separates a successful "disincorporation" case from a doomed one lies more in the ability of the parties and counsel to identify, avoid or successfully navigate the myriad of issues that inevitably may – or undoubtedly will – arise whenever this creative legal strategy is employed.

Ideally, this paper and its related presentation will explore and identify many of the issues that counsel, their clients, and the Courts may wish to consider when faced with a so-called "disincorporation" case. To be sure, there are many. And it is equally worth noting that the unintended consequences of pursuing such a legal strategy oftentimes eclipses or overtakes the actually intended and desired consequences of the practice. So while there are undeniable efficiencies and valuable ends to be achieved when this creative bankruptcy practice is performed well and thoughtfully, there are substantial risks and detriments involved as well when it is not.

In order to best discuss the practice itself and identify the many issues for consideration for both debtor's and creditor's counsel, this paper will first present a typical-hypothetical "disincorporation" fact pattern for discussion, then a general overview of the disincorporation practice, and finally enumerate with some discussion the variety of issues for consideration by all counsel (and the Bankruptcy Courts) when faced with such a matter.

Hypothetical[2]

Prepetition

Ministry of Truth, P.A.

In 1984, Ministry of Truth, P.A. ("Ministry of Truth") files its Articles of Incorporation with the Oceania Secretary of State (the "SOS") thereby becoming an Oceania professional corporation. Winston Smith ("Winston") is the 100% shareholder and President of Ministry of Truth. Ministry of Truth provides thought-wellness services to residents of Oceania.

Victory Mansions, LLC

Later that same year, Victory Mansions, LLC ("Victory Mansions") files its Articles of Incorporation with the SOS thereby becoming an Oceania limited liability company. Winston is the 50% member of Victory Mansions, along with his wife, Julia, the other 50% member. Victory Mansions is engaged in the real estate rental business in Oceania.

Big Brother Bank

Six weeks after its formation, Victory Mansions enters into a business loan agreement with Big Brother Bank ("BBB"), and it delivers a note to BBB for $250,000. To secure the note, Victory Mansions gives BBB a mortgage against real property located at Airstrip One, Oceania ("Airstrip One"). As further security for the note, Ministry of Truth grants BBB a security interest in all its commercial personal property and equipment.

Four months later, Ministry of Truth also enters into a business loan agreement with BBB, and it delivers a note to BBB for $250,000. To secure the note, Ministry of Truth grants BBB a security interest in all its commercial personal property assets and accounts.

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[2] All persons, entities, and events are fictitious. Any resemblances or similarities to actual persons or events are purely coincidental. Special thanks to Eric Blair.

Winston, Julia, and Ministry of Truth execute commercial guaranties for the debts of Victory Mansions to BBB. Similarly, Winston, Julia, and Victory Mansions also execute commercial guaranties for the debts of Ministry of Truth to BBB.

Winston and Julia are employed by Ministry of Truth. Ministry of Truth conducts its business at Airstrip One, which is owned by Victory Mansions, and Victory Mansions rents Airstrip One to Ministry of Truth on a monthly basis.

Forbearances and Workout

Beginning in 1985 and continuing thereafter through 2014, the parties' business loans, notes, mortgages, security instruments, and guarantees go through a number of modifications, amendments, and forbearances as a result of on-going financial difficulties experienced by both Ministry of Truth and Victory Mansions.

In September 2014, the parties sign a forbearance agreement for all the direct loans and guaranties of the commercial debts due and owing to BBB ($500,000), which are all in default. Under the forbearance agreement, BBB extends the maturity date for the repayment of the entirety of the debts to September 2015 (1 year later).

Prepetition Defaults, Power of Sale Foreclosure, and Secured-Party Sale

Unfortunately, following the execution of the forbearance agreement, a substantial client of Ministry of Truth refuses to pay it for questionable thought-wellness services, and Ministry of Truth and Victory Mansions again default on their business loan obligations to BBB.

On May 1, 2015, BBB notifies Winston, Julia, Ministry of Truth, and Victory Mansions of their defaults under the loans and guaranties and it accelerates the debts.

On August 6, 2015, BBB records in the Oceania Registry of Deeds a notice of foreclosure sale with respect to Airstrip One (owned by Victory Mansions) under Oceania's commercial power of sale foreclosure statutes. At the same time, BBB provides a secured-party sale notice of the commercial personal property equipment owned by Ministry of Truth.

Per the notices, a public auction sale of Airstrip One is scheduled for September 1, 2015. The notices also provide that a timed, public on-line auction for the Ministry of Truth personal property assets will take place between August 16 and September 1, 2015.

On August 7, 2015, Winston, Julia, Ministry of Truth, and Victory Mansions receive actual notice of the sale notices and the auctions scheduled for August 16 and September 1, 2015.

Prepetition Transfers

On August 25, 2015 – 18 days after receipt of the sale notices and 6 days prior to the foreclosure sale of Airstrip One – Winston, in his capacity as manager of Victory Mansions, transfers via a "Warranty Deed" Airstrip One from Victory Mansions to Winston in his personal capacity. The Warranty Deed is recorded with the Oceania Registry of Deeds that day.

Winston also, in his capacity as manager of Victory Mansions and President of Ministry of Truth, transfers all the commercial personal property assets of those two entities to himself in his personal capacity. Some of those personal property assets are accounts receivable of Ministry of Truth, all of its thought-wellness services equipment, and a variety of manuals on Newspeak.

At no time does BBB consent to the transfer of Airstrip One or any of its commercial personal property collateral. In fact, BBB does not even know the transfers occurred, which is stunning really, as BBB is always watching. Always.

<u>The Chapter 13 Case</u>

On August 26, 2015, the day after he causes Victory Mansions to transfer – without BBB's knowledge or consent – Airstrip One to himself personally in order to avoid and prevent the foreclosure sale from occurring 6 days later on September 1, Winston files a Chapter 13 case.

Because Winston on the filing date is the nominal title owner of Airstrip One, the automatic stay under § 362(a) of the Bankruptcy Code (which applies even in Oceania – nothing can stop the Bankruptcy Code, not even dystopia!) prevents BBB with proceeding with the foreclosure sale on September 1. BBB is not happy.

Similarly, BBB cancels the personal property auction due to the commencement of Winston's Chapter 13 case and the potential application of the automatic stay under § 362 of the Code to all its personal property collateral.

Winston's Schedule A lists his "fee simple" interest in Airstrip One in the amount of $300,000. Notably, although the Warranty Deed indicates that Airstrip One was transferred for cash received, Winston's Statement of Financial Affairs lists no transfers of any money or value from Winston to Victory Mansions within the 90 days or 2 years immediately preceding the filing date.

Winston's Schedule B lists accounts receivable in the amount of $25,000 and thought-wellness services equipment with a value of $10,000. The value of the Newspeak manuals is "unknown" (undoubtedly because they are invaluable and cannot be ascribed any true monetary value).

Shortly after the commencement of his Chapter 13 case, Winston proposes a Chapter 13 plan that will cramdown BBB's secured claim, pursuant to § 506 of the Code, to the value of Airstrip One ($300,000), and then to pay that secured claim during the term of his plan. BBB's bifurcated unsecured claim will be discharged after receiving a tiny distribution. BBB is not happy. And now it is most definitely watching Winston and his Chapter 13 case – very, very closely.

What is a "Disincorporation" Case Really?

As an initial matter, in virtually all instances (including the one above), the very description of this legal practice or strategy as being a "disincorporation" case is a misnomer. The transfer of substantially all a corporate entity's assets to its insider (together with the insider's actual or purported personal assumption of all the entity's liabilities or debts) does not result in the disincorporation or dissolution of that entity under applicable state law. The entity still exists. It has not been disincorporated in any legally recognizable or statutorily mandated way – it just simply does not possess any of its assets any longer. They have all been transferred to its insider, with the insider often (but not always) personally assuming the debts of the corporate entity (many of which, at least as far as secured debt is concerned, the insider is already obligated upon by virtue of a personal guaranty).

Nevertheless, the practice has come to be known as "disincorporation" in common parlance, and for the most part in those jurisdictions where it occurs, it is a Chapter 13 strategy that has gone essentially unchallenged. The reasons given for such disincorporation cases and resultant Chapter 13 filings are varied: Ranging from a desire to avoid the administrative expense and seeming complexity of Chapter 11 practice and cases, to streamlining two potential bankruptcy cases (one for the corporate entity, the second for the insider/guarantor) into a single bankruptcy proceeding for the benefit of the insider with the more pressing financial interests at stake, or being attributable to simply creative lawyering on the part of debtors' counsel in the District.

Depending on your perspective, the practice is either perhaps a laudable and pragmatic approach to the restructuring of corporate and/or personal debts in one efficient and cost-effective proceeding, or, it is an absolute gerrymandering and abuse of the Bankruptcy Code and applicable non-bankruptcy law. Lawyers tend not to have neutral views on the practice. They either think it is perfectly acceptable, if not entirely desirable and appropriate (not unsurprisingly, generally debtor's counsel), or they loathe the practice and consider it an affront to all that is right, just, and good (*i.e.*, creditor's rights lawyers).

Now, in order to successfully accomplish a disincorporation case, debtor's counsel must absolutely forecast and anticipate a multitude of issues and tasks that will be necessary to best put their client (who is their client, by the way, the insider? The corporate entity? Both?) in a position to succeed. Secured creditor's counsel, on the other hand, has an almost limitless number of tools and levers at their disposal to challenge the propriety of such a case, and whether they use and pull all those tools and levers in most instances depends on the pragmatism/annoyance of their client (*i.e.*, the bank), and whether the bank thinks it is going to get paid in the case, how much, and when.

The bullet points and topics below will explore many of those various issues and tasks from the perspectives of both the creditor and the debtor.[3]

[3] With their gracious express permission, a good deal of the itemized issues and points for consideration for both debtor's and creditor's counsel in disincorporation cases presented herein are derived from written materials on this same disincorporation topic presented by James F. Molleur, Esq. and Jacob A. Manheimer, Esq. at the Judicial Conference for the United States District Court for the District of Maine in October 2016. Both Attorney Molleur (of Molleur Law Office) and Attorney Manheimer (of Pierce Atwood LLP) are well-established and universally-respected bankruptcy and workout attorneys across all Chapters of the Bankruptcy Code, and their contributions to this presentation are much appreciated.

ISSUES, TASKS, AND CONSIDERATIONS FOR DEBTOR'S COUNSEL

1. What is the purpose of any transfers for reorganization (*see, e.g.*, 11 U.S.C. § 362(d)(4));

2. Transfer of any assets must be for value (assumption of debt) (*see, e.g.*, 11 U.S.C. § 548(d)(2) (A) and Uniform Fraudulent Transfer Acts);

3. Necessity of corporate/LLC authorization for transfers;

4. Disincorporation acceptable for S-Corps., but not C-Corps.;

5. Usually single member or closely held corporation/LLC;

6. Transfer of assets can include titled vehicles; registration requirements;

7. Corporate/LLC bank accounts need to be closed and new sole proprietor bank accounts opened;

8. Real estate must be transferred before filing date;

9. New E.I.N. needed;

10. Any government licenses/permits must be addressed/transferred;

11. Separate classifications and/or treatment for former corporate/LLC creditors regarding assets transferred to insider;

12. Eligibility limits for Chapter 13, *see*, e.g., 11 U.S.C. § 109(e); and

13. Anti-assignment clauses in contracts and third-party consents to assignments.

14. Separate counsel for insider and/or corporation/LLC?

15. Fiduciary obligations to corporation/LLC?

16. Does corporation or LLC have claim (i.e., becomes a creditor) of insider by virtue of transfers of its assets? Do creditors of the corporation/LLC have claims against insider, even if not guaranty creditors by virtue of transfers?

ISSUES, TASKS, AND CONSIDERATIONS FOR CREDITOR'S COUNSEL

A. Initial Considerations

1. Are there sources of repayment other than the debtor and property of the estate?
2. Does the creditor have offset rights?
3. Did the creditor receive a preference?
4. Is the creditor's claim subject to subordination?
5. Is the creditor's lien valid and perfected?
6. Is the creditor's lien subject to avoidance?
7. Does the amount of the debt exceed the value of the collateral?
8. Does the lien impair an exemption?
9. Is action required to avoid expiration of creditor's rights?
10. Does the debtor have the right to cure arrearages and reinstate the payment schedule? (Non-monetary default, like lapse in life insurance?)
11. Exactly what is the collateral? (If blanket lien, cover all personal assets too?)
12. Is there a need to protect cash collateral? (What if account still in business' name?)
13. Does the debtor want or need the collateral?
14. What are the risks to the collateral or its value during pendency of case? What protection is needed?
15. To what extent is the claim secured?

16 Is interest accruing?

17. Is the creditor entitled to recover attorneys' fees?
18. Is there a risk of a § 506(c) claim? (What about § 506(a)(2) valuation differences)

19. Does the creditor have any affirmative duties?

20. Is the reorganization or chapter 13 plan feasible?

21. Is this a single asset real estate case?

22. Is the claim nondischargeable? §523(a)(4) fraud while fiduciary, embezzlement?

23. Is the claim secured by a purchase money security interest in aircraft equipment or vessels?

24. Would credit fare better if corporate entities had each filed Chapter 11s?

B. Differences in business reorganizations under Chapter 11 and Chapter 13

1. Periodic financial reporting (but Chapter 13 debtor doing business must file reporting similar to that in Chapter 11 as to business operation, *see* §1304; § 704(a)(8);

2. Contents of plan;

3. Voting;

4. Confirmation § 1324(b) 45 day time limit

a. Section 1325(a)(5)

i. Holder of secured claim accepts plan; or

ii. Holder of secured claim retains lien and receives value under the plan equal to value of collateral in equal periodic payments and payment stream provides adequate protection of personal property collateral; or

iii. Debtor surrenders collateral.

b. Section 1129(a)(7) and (b)(2)(a).

i. Holder of secured claim accepts plan; or

ii. Holder of secured claim retains lien or receives value under the plan equal to value of collateral; or

iii. In event of § 1111(b) election, holder of secured claim retains lien and receives payments under the plan equal to the amount of the claim; or

iv. Holder of secured claim receives "indubitable equivalent" of value of collateral (including surrender or proceeds of sale).

5. Section 1111(b) election.

6. Debtor's duties during Chapter 13 plan period.

7. Method of Valuation (§ 506(a)(2) "replacement value" or going concern under Chapter 11?

C. Considerations in Chapter 13 "Disincorporation" Cases

1. Part of scheme to "hinder, delay or defraud"?

2. Express assumption of indebtedness?

3. Transfer of all business assets?

4. Effect of transfers on assets (*e.g.* licenses and permits)?

5. Compliance with non-bankruptcy law?

6. Employees?

7. Consent of creditors and contract counter-parties?

8. Financial reports?

9. Is any Power of Sale provision destroyed when individual assumes loans?

D. Options

1. File motion to prohibit or condition use of cash collateral.

2. File motion to dismiss or convert.

3. File motion for adequate protection.
4. File motion for relief from stay.
5. File motion for valuation of collateral.
6. Seek abandonment.
7. Seek sale under § 363.
8. File objection to plan confirmation.
9. Vote to reject plan.
10. File proof of claim.
11. Make § 1111(b) election.
12. Move to shorten or terminate exclusivity.
13. Negotiate.

E. Adequate Protection

1. Acknowledgment/approval by court of amount of indebtedness.
2. Acknowledgement/approval by court of priority and enforceability of liens.
3. Acknowledgement of default.
4. Periodic payments.
    a. Application of payments.
    b. Cure of arrearages.
    c. Payments outside plan in Chapter 13. Default is the assignment itself/substitution of individual for the business. Cure would be to unwind the assignment.
5. Payment of insurance premiums.
6. Payment of real and personal property taxes.

7. Waiver of surcharge.

8. Financial reporting.

9. No additional indebtedness secured by collateral (senior, pari passu or junior).

10. Right to inspect and audit.

11. No proposed sale without consent.

12. Right to credit bid.

13. Right to payment upon sale.

14. Waiver of credits.

15. Relief from stay upon default:

    a. Dismissal or conversion to chapter 7.

    b. Failure to confirm plan by date certain.

    c. Entry of order authorizing sale without payment upon sale.

    d. Cessation of business operations.

    e. Material misrepresentation.

    f. Default in any covenant above.

16. Binding on successors and assigns, including chapter 7 trustee.

17. Survival.

F. How Creditors May Protect Themselves.

1. Include explicit clause in loan documents that states any nonconforming transfer or assignment is "void" or "invalid" and that the assignee shall acquire no rights in the property.

    a. <u>Restatement (Second) of Contracts § 322</u>: "A contract term prohibiting assignment of rights under the contract, unless a different intention is manifested . . . gives the obligor a right to damages for breach of the terms forbidding assignment but does not render the assignment ineffective."

b. 29 Williston on Contracts § 74.22 (4th Ed): "[C]ontractual provisions limiting or prohibiting assignments operate only to limit a party's right to assign the contract, but not its power to do so, *unless the parties manifest and intent to the contrary with specificity*." (emphasis added).

c. 11 U.S.C. § 541(c)(1)(A): Any interest of the debtor in property becomes property of the estate notwithstanding any contractual provision "that restricts or conditions transfer of such interest by the debtor." - Here the restriction is on, and the transfer would be made by, the business, which is not a "debtor" in the bankruptcy, so this does not apply.