

SPOTTING AN INSOLVENT CLIENT AND THE ACCOUNTANT'S ROLE IN A BANKRUPTCY CASE

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Signs of Insolvency

1. Not paying ordinary course debts as they become due.
2. Borrowing from multiple banks in a short period of time.
3. Inability to borrow from a commercial lender.
4. Default of commercial loans, especially a secured loan.
5. Use of personal charge cards to run the business and pay ordinary course business obligations.
6. Failure of principal to take compensation.
7. Failure to pay payroll taxes.
8. Failure to make contractual fringe benefit contributions.

The Company Has Not Been Paying Its Payroll Taxes

One of the key signs of insolvency is failure to pay payroll taxes (and failure to pay fringe benefit contributions). In short, the company is “borrowing” from the government and its employees, rather than obtaining a commercial loan. This creates problems for both the company, the owner and anyone designated as a responsible party.

The Company

- If the taxes are significant enough, the taxing authority (e.g. IRS or Michigan Dept. of Treasury), can file a lien on the company's assets. The lien is filed with the Secretary of State, UCC division, and is given priority in accordance with its date of filing.
- However, after 45 days, a tax lien primes any commercial lender who is secured in the company's accounts receivable and assets acquired after the 45-day period. Therefore, after 45 days from when the tax lien is filed, the commercial lender becomes junior to the tax lien relative to the debtor's receivables, resulting cash and post-45-day advances.

The Company

- Michigan Law 205.29 Taxes, interest, and penalties as lien.
- Federal Law 26 U.S. Code § 6321. Lien for taxes.
- 26 U.S. Code § 6323. Validity and priority against certain persons.

The Filing of a Tax Lien has Various Consequences

- It is almost certainly an event of default under the loan documents with a commercial lender.
- It creates more than one creditor that has to be dealt with if the debtor files a chapter 11 and needs the use of cash collateral or needs debtor-in-possession financing.

Responsible Party Treatment by the Taxing Authority

- Generally, the responsible party “had the duty to account for, collect, and pay over the trust fund taxes to the government; and the person ‘willfully’ failed to collect or pay over trust fund taxes to the government.”
- The taxing authority will generally take steps to assess the responsible party.
- Payroll taxes assessed against a responsible party are never dischargeable in a bankruptcy.
- If a lien is assessed against the responsible party, there is no discharge of the secured debt.
- Lien against a house, even if jointly owned, stands.

Responsible Party Treatment by the Taxing Authority

- Notice of Federal tax lien attaches to all property, and defeats an individual debtor's exemptions.
- If the tax is otherwise dischargeable, the lien doesn't attach to after-acquired property.
- If the tax is otherwise non-dischargeable, the lien remains and continues as if there were no bankruptcy filing. See IRS Publication 5.17.7 "Liability of Third Parties for Unpaid Employment Taxes" July 18, 2012, https://www.irs.gov/irm/part5/irm_05-017-007.
- The company's portion of the payroll tax is dischargeable by a debtor.

Accountant's Role in a Bankruptcy Case

- THE COMPANY FILES FOR BANKRUPTCY.
 1. Accountant's role:
 - a. Getting hired as accountant for the debtor
 - i. Disinterestedness
 - ii. Prepetition fees/payment/waiver

Accountant's Role in a Bankruptcy Case

- b. The best thing you can do for the client is to make sure that their books and records are in good shape before they file.
- c. Tax returns should be current
 - i. Chapter 7
 - (a) The filing of date of personal tax returns affects whether or not an income tax obligation is dischargeable or not. (This is true under all types of bankruptcies.)

Accountant's Role in a Bankruptcy Case

11 U.S.C. §523(a). Exceptions to Discharge.

Certain tax obligations are subject to priority above unsecured creditors under 11 U.S.C. §507(a) (8). (This is true under all types of bankruptcies.)

11 U.S.C. §507(a)(8) – Priorities.

Chapter 13

- 11 U.S.C. §1308 Filing of prepetition tax returns



Chapter 11

- 11 USC §308 Debtor Reporting Requirements
- 11 USC §1116 Duties of Trustee or Debtor in Possession in small business cases



Chapter 11

- 11 USC §327 Employment of Professional Persons
- A professional has to certify it does “not hold or represent an interest adverse to the estate, and that [it is a] “disinterested persons” 11 U.S.C. §104(14):
- The term “disinterested person” means a person that:
 - (A) is not a creditor, an equity security holder, or an insider;

Chapter 11

- (B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and
- (C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.

Chapter 11

- Certification is by an Affidavit. The key to any application and affidavit is to disclose any and all possible conflicts or possible issues at the beginning of the process.



Chapter 11

(i) Practice Pointer: if you are owed fees prepetition and want to continue to represent a client who is a debtor, you can waive the fees to avoid being disqualified as not being a disinterested person. If you received payment within 90 days, that sets you up for a preference claim; there is case law which says that a professional is not disinterested if there could be any claims against that professional in the bankruptcy case (including a possible preferential transfer). Waiver of the claim and repayment of the alleged preference payment should avoid any conflict. One way to avoid this situation may be to receive a retainer in the 90 day period and work off of the retainer. Any issue regarding disinterestedness should be resolved at the beginning of a case or when there is the first opportunity for employment. Failure to do so could result in work being performed and then the professional not being compensated.

Chapter 11

- Preparation for First Day hearings in a chapter 11 case - projections for cash collateral/debtor-in-possession loan/-budget
 - Debtor needs to show that it can support the use of cash collateral, and that there will not be any diminution in value to the secured lender. Among the factors for this are:
 - Showing sales projections/cash flow from operations (historical data is important to support projections).
 - Value of fixed assets that are subject to both pre-petition and post-petition liens.
 - Operating budget going forward a number of weeks, and continued update of the budget throughout the case.
 - Monthly financial statements--Required by the Office of the U.S. Trustee. See, generally, https://www.justice.gov/ust-regions-r09/file/6de_oirr_debtor_package.pdf/download

Chapter 11

- Formulation of chapter 11 plan/projections for confirmation
 - Need to have going forward budget/ operations for the term of the plan to show that the payment plan is feasible.
 - Need to show that the debtor's assets on liquidation are less than or equal to the amount that is proposed to be paid back to unsecured creditors.

Potential for Conflicts

- Client/Debtor Is A Small Business. Principal Of The Business Loans Money To The Company. Principal Also Works For The Company.
 - Principal wants to avoid income taxes so takes his “compensation” in the form of loan repayment.
 - This creates a serious issue for the principal of the company. In the event of a bankruptcy by the company, loan repayments made within a year of filing of the bankruptcy are preference payments, subject to recovery by the trustee, if a chapter 7, or by the debtor/creditors’ committee, if a chapter 11. 11 U.S.C. §547(b).

Potential for Conflicts

- There could also be a claim that this is a voidable transaction (formerly known as a “fraudulent conveyance”) if the transfers were made while the company was insolvent or if the transfers rendered the company insolvent. In a bankruptcy case, the statute of limitations is the later of 2 years from the date of filing (order for relief), or 1 year from the date a trustee is appointed under Section 546(a)(1) of the Bankruptcy Code, if the appointment is before the expiration of the 2-year period. Under the Bankruptcy Code, 11 U.S.C. §548(a), the Trustee can look at transfers that occurred up to 2 years before the petition date.

Potential for Conflicts

- Under Michigan Law, the Uniform Voidable Transactions Act, MCL 566.31 et seq, the look back period is 6 years, coinciding with the statute of limitations of 6 years after the claims accrue or 2 years from the discovery of concealment of the claim, MCL 566.39.

Potential for Conflicts

- Issues of imputed income to the principal, as well as unpaid withholding taxes (employee's and employer's portion) to the company.
- If there are unpaid withholding taxes, there are issues for the responsible party.

Potential for Conflicts

- The Principal Of The Company Is Covering Company Obligations.

The principal is using personal credit cards to prop up the company. Use of personal credit to pay for things for the company is a loan to the company. This will be analyzed by creditors/ a trustee in the same way as repayment of other loan obligations to the principal, and can result in claims against the principal for preference recovery and avoidable transfers.

Potential for Conflicts

- There is a cascading effect to the insolvency of a company.
- The principal may have guaranteed other obligations, such as a secured lender, and may have given collateral in support of the guaranty. Sometimes, with a small company, both the principal and spouse will sign a guaranty. This creates risk for the couple relative to jointly held property, including real estate.

Potential for Conflicts

- Issues about representing the company and the guarantors as tax advisor - is this a conflict?
- Does this affect the disinterestedness requirement?
- Some considerations are whether the company and guarantor have claims against one another and whether their interests diverge in a material way.