

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

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I. SIGNS OF INSOLVENCY

A. There are many things that can alert an accountant to a client's financial issues. Here is a list of common indications that a company is experiencing financial difficulties. As with most things, addressing the potential insolvency as soon as possible is the best course of action. Nothing ever gets better by waiting, and the options for solving problems diminish as more time passes.

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.

Some of these factors have significant consequences that go beyond whether or not the company can continue to operate and stay in business. In particular, failure to pay payroll taxes can have extensive consequences.

B. The Company Has Not Been Paying Its Payroll Taxes.

1. 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.

2. The Company:

a. 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.

b. 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.

i. Michigan Law

205.29 Taxes, interest, and penalties as lien.

Sec. 29.

(1) Taxes administered under this act, together with the interest and penalties on those taxes, shall be a lien in favor of the state against all property and rights of property, both real and personal, tangible and intangible, owned at the time the lien attaches, or afterwards acquired by any person liable for the tax, to secure the payment of the tax. The lien shall attach to the property from and after the date that any report or return on which the tax is levied is required to be filed with the department and shall continue for 7

years after the date of attachment. The lien may be extended for another 7 years by refiling pursuant to subsection (2) if the refiling is made within 6 months prior to the expiration date of the original 7-year period.

- (2) The lien imposed by this act shall take precedence over all other liens and encumbrances, except bona fide liens recorded before the date the lien under this act is recorded. However, bona fide liens recorded before the lien under this act is recorded shall take precedence only to the extent of disbursements made under a financing arrangement before the forty-sixth day after the date of the tax lien recording, or before the person making the disbursements had actual knowledge of a tax lien recording under this act, whichever is earlier. A lien shall be recorded and discharged in accordance with Act No. 203 of the Public Acts of 1968, as amended, being sections 211.681 to 211.687 of the Michigan Compiled Laws.
- (3) A purchaser or succeeding purchaser of property, from a taxpayer in other than the ordinary course of business, against which a lien has been properly recorded pursuant to subsection (2) shall be personally liable for the unpaid taxes which are due on the lien. The purchaser's liability shall be limited to the value of the property less any proceeds which were applied to balances due on secured interests which are superior to the lien recorded under subsection (2).

ii. Federal Law

26 U.S. Code § 6321. Lien for taxes

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

26 U.S. Code § 6323. Validity and priority against certain persons

(d) 45-day period for making disbursements. Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing by reason of disbursements made before the 46th day after the date of tax lien filing, or (if earlier) before the person making such disbursements had actual notice or knowledge of tax lien filing, but only if such security interest—

(1) is in property

(A) subject, at the time of tax lien filing, to the lien imposed by section 6321, and

(B) covered by the terms of a written agreement entered into before tax lien filing, and

(2) is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

c. The filing of a tax lien has various consequences:

i. it is almost certainly an event of default under the loan documents with a commercial lender.

ii. 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.

3. Responsible party treatment by the taxing authority:

a. 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.”¹

- b. The taxing authority will generally take steps to assess the responsible party.
 - c. Payroll taxes assessed against a responsible party are never dischargeable in a bankruptcy.
 - d. If a lien is assessed against the responsible party, there is no discharge of the secured debt.
 - e. Lien against a house, even if jointly owned, stands.
 - f. Notice of Federal tax lien attaches to all property, and defeats an individual debtor’s exemptions.
 - g. If the tax is otherwise dischargeable, the lien doesn’t attach to after-acquired property.
 - h. If the tax is otherwise non-dischargeable, the lien remains and continues as if there were no bankruptcy filing.
4. The company’s portion of the payroll tax is dischargeable by a debtor.

II. ACCOUNTANT’S ROLE IN A BANKRUPTCY CASE

A. THE COMPANY FILES FOR BANKRUPTCY.

- 1. Accountant’s role:
 - a. Getting hired as accountant for the debtor

¹ 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.

i. Disinterestedness

ii. Prepetition fees/payment/waiver

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

ii. 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.)

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

(a) A discharge under section 727, 1141, 1192 [1] 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

(A) of the kind and for the periods specified in section 507(a)(3) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, or equivalent report or notice, if required—

(i) was not filed or given; or

(ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax;

- (b) 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. Priorities.

(a)(8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for—

(A) a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition—

(i) for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;

(ii) assessed within 240 days before the date of the filing of the petition, exclusive of—

(I) any time during which an offer in compromise with respect to that tax was pending or in effect during that 240-day period, plus 30 days; and

(II) any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days; or

(iii) other than a tax of a kind specified in section 523(a)(1)(B) or 523(a)(1)(C) of this title, not assessed before, but assessable, under applicable law or by agreement, after, the commencement of the case;

(B) a property tax incurred before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition;

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity;

(D) an employment tax on a wage, salary, or commission of a kind specified in paragraph (4) of this subsection earned from the debtor before the date of the filing of the petition, whether or not actually

paid before such date, for which a return is last due, under applicable law or under any extension, after three years before the date of the filing of the petition;

(E) an excise tax on—

(i) a transaction occurring before the date of the filing of the petition for which a return, if required, is last due, under applicable law or under any extension, after three years before the date of the filing of the petition; or

(ii) if a return is not required, a transaction occurring during the three years immediately preceding the date of the filing of the petition;

(F) a customs duty arising out of the importation of merchandise—

(i) entered for consumption within one year before the date of the filing of the petition;

(ii) covered by an entry liquidated or re-liquidated within one year before the date of the filing of the petition; or

(iii) entered for consumption within four years before the date of the filing of the petition but unliquidated on such date, if the Secretary of the Treasury certifies that failure to liquidate such entry was due to an investigation pending on such date into assessment of antidumping or countervailing duties or fraud, or if information needed for the proper appraisal or classification of such merchandise was not available to the appropriate customs officer before such date; or

(G) a penalty related to a claim of a kind specified in this paragraph and in compensation for actual pecuniary loss.

- i. An otherwise applicable time period specified in this paragraph shall be suspended for any period during which a governmental unit is prohibited under applicable non-bankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days; plus any time during which the stay of proceedings was in effect in a prior case under this title or during which collection

was precluded by the existence of 1 or more confirmed plans under this title, plus 90 days.

iii. Chapter 13

(a) 11 U.S.C. §1308 Filing of prepetition tax returns.

(a) Not later than the day before the date on which the meeting of the creditors is first scheduled to be held under section 341(a), if the debtor was required to file a tax return under applicable nonbankruptcy law, the debtor shall file with appropriate tax authorities all tax returns for all taxable periods ending during the 4-year period ending on the date of the filing of the petition.

(b)(1) Subject to paragraph (2), if the tax returns required by subsection (a) have not been filed by the date on which the meeting of creditors is first scheduled to be held under section 341(a), the trustee may hold open that meeting for a reasonable period of time to allow the debtor an additional period of time to file any unfiled returns, but such additional period of time shall not extend beyond—

(A) for any return that is past due as of the date of the filing of the petition, the date that is 120 days after the date of that meeting;
or

(B) for any return that is not past due as of the date of the filing of the petition, the later of—

(i) the date that is 120 days after the date of that meeting;
or

(ii) the date on which the return is due under the last automatic extension of time for filing that return to which the debtor is entitled, and for which request is timely made, in accordance with applicable nonbankruptcy law.

(2) After notice and a hearing, and order entered before the tolling of any applicable filing period determined under paragraph (1), if the debtor demonstrates by a preponderance of the evidence that the failure to file a return as required under paragraph (1) is attributable to circumstances beyond the control of the debtor, the court may extend the filing period established by the trustee under paragraph (1) for—

(A) a period of not more than 30 days for returns described in paragraph (1)(A); and

(B) a period not to extend after the applicable extended due date for a return described in paragraph (1)(B).

(c) For purposes of this section, the term “return” includes a return prepared pursuant to subsection (a) or (b) of section 6020 of the Internal Revenue Code of 1986, or a similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal.

iv. Chapter 11

(a) 11 USC §308 Debtor Reporting Requirements

(a) For purposes of this section, the term “profitability” means, with respect to a debtor, the amount of money that the debtor has earned or lost during current and recent fiscal periods.

(b) A debtor in a small business case shall file periodic financial and other reports containing information including—

(1) the debtor’s profitability;

(2) reasonable approximations of the debtor’s projected cash receipts and cash disbursements over a reasonable period;

(3) comparisons of actual cash receipts and disbursements with projections in prior reports;

(4) whether the debtor is—

(A) in compliance in all material respects with postpetition requirements imposed by this title and the Federal Rules of Bankruptcy Procedure; and

(B) timely filing tax returns and other required government filings and paying taxes and other administrative expenses when due;

(5) if the debtor is not in compliance with the requirements referred to in paragraph (4)(A) or filing tax returns and other required government filings and making the payments referred to in paragraph (4)(B), what the failures are and how, at what cost, and when the debtor intends to remedy such failures; and

(6) such other matters as are in the best interests of the debtor and creditors, and in the public interest in fair and efficient procedures under chapter 11 of this title.

(b) 11 USC §1116 Duties of Trustee or Debtor in Possession in small business cases

In a small business case, a trustee or the debtor in possession, in addition to the duties provided in this title and as otherwise required by law, shall—

(1) append to the voluntary petition or, in an involuntary case, file not later than 7 days after the date of the order for relief—

(A) its most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return; or

(B) a statement made under penalty of perjury that no balance sheet, statement of operations, or cash-flow statement has been prepared and no Federal tax return has been filed;

(2) attend, through its senior management personnel and counsel, meetings scheduled by the court or the United States trustee, including initial debtor interviews, scheduling conferences, and meetings of creditors convened under section 341 unless the court, after notice and a hearing, waives that requirement upon a finding of extraordinary and compelling circumstances;

(3) timely file all schedules and statements of financial affairs, unless the court, after notice and a hearing, grants an extension, which shall not extend such time period to a date later than 30 days after the date of the order for relief, absent extraordinary and compelling circumstances;

(4) file all post-petition financial and other reports required by the Federal Rules of Bankruptcy Procedure or by local rule of the district court;

(5) subject to section 363(c)(2), maintain insurance customary and appropriate to the industry;

(6)

(A) timely file tax returns and other required government filings; and

(B) subject to section 363(c)(2), timely pay all taxes entitled to administrative expense priority except those being contested by appropriate proceedings being diligently prosecuted; and

(7) allow the United States trustee, or a designated representative of the United States trustee, to inspect the debtor's business premises, books, and records at reasonable times, after reasonable prior written notice, unless notice is waived by the debtor.

iv. Accountant for the debtor, trustee or creditors committee—
what is involved

(a) Employment of professionals. Governed by Code §327(a), by application to and appointment by the court. Code § 327(b) provides that the debtor can retain or replace pre-petition professionals. During the course of a case, professionals apply for compensation in accordance with the Code requirements and local rules of the jurisdiction.

11 USC §327 Employment of Professional Persons.

(a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

(b) If the trustee is authorized to operate the business of the debtor under section 721, 1202, or 1108 of this title, and if the debtor has regularly employed attorneys, accountants, or other professional persons on salary, the trustee may retain or replace such professional persons if necessary in the operation of such business.

(c) In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

(b) 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):

(14) The term "disinterested person" means a person that—

(A) is not a creditor, an equity security holder, or an insider;

(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.
- (c) 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.
- (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.
- (d) Preparation for First Day hearings in a chapter 11 case—projections for cash collateral/debtor-in-possession loan/budget
- i. 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:
 - ii. Showing sales projections/cash flow from operations (historical data is important to support projections).
 - iii. Value of fixed assets that are subject to both pre-petition and post-petition liens.

iv. Operating budget going forward a number of weeks, and continued update of the budget throughout the case.

v. 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.

(e) Formulation of chapter 11 plan/projections for confirmation

i. Need to have going forward budget/operations for the term of the plan to show that the payment plan is feasible.

ii. 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.

III. POTENTIAL FOR CONFLICTS

A. Client/Debtor Is A Small Business. Principal Of The Business Loans Money To The Company. Principal Also Works For The Company.

1. Principal wants to avoid income taxes so takes his "compensation" in the form of loan repayment.

a. 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).

i. 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.

ii. 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.

b. Issues of imputed income to the principal, as well as unpaid withholding taxes (employee's and employer's portion) to the company.

c. If there are unpaid withholding taxes, there are issues for the responsible party.

B. 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.

1. There is a cascading effect to the insolvency of a company.

2. 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.
3. 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.