Pointers & Pitfalls

Legal Insights for the Business World

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A SUMMARY OF CASES AND RECENT COMMERCIAL DEVELOPMENTS COMPILED AND EDITED BY THE ATTORNEYS OF LAMBERTH, BONAPFEL, CIFELLI & STOKES, P.A.

Welcome to the first edition of Pointers & Pitfalls, a publication of Lamberth, Bonapfel, Cifelli & Stokes, P.A. This quarterly publication will provide to you a summary of recent developments relating to various commercial law issues. We hope you will find this publication helpful. Lamberth, Bonapfel, Cifelli & Stokes, P.A. has a general civil practice with concentrations in debtor/creditor relations, including corporate reorganizations, work-outs, and commercial litigation. The firm also provides representation to small- and medium-size businesses. For over twenty-five years, the firm has enjoyed success in assisting businesses and individuals in resolving complex legal problems.

1997 TURNAROUND OF THE YEAR.

Lamberth, Bonapfel, Cifelli & Stokes, P.A. played a major role in the turnaround of First American Health Care, Inc., which was the country's largest privately owned home health care company and a major provider of Medicare reimbursed, in-home nursing care. Ten days after the company and its owners were convicted of Medicare fraud, all Medicare payments to the company were cut off, effectively putting the company out of business. The new management team of Chamberlain & Cansler executed a remarkable turnaround utilizing bankruptcy protection to restore Medicare funds, negotiation to settle seven years of outstanding claims with Medicare, cost reduction to restore positive cash flow and a renegotiated merger agreement to increase proceeds from the sale of the company. Lamberth, Bonapfel, Cifelli & Stokes, P.A. served as Chapter 11 counsel for the Debtor. Paul Bonapfel was the lead bankruptcy counsel.

NATIONAL BANKRUPTCY REVIEW COMMISSION ISSUES REPORT.

The National Bankruptcy Review Commission is an independent Commission established as part of the Bankruptcy Reform Act of 1994. The Commission was created to: (1) investigate and study issues relating to the Bankruptcy Code; (2) solicit divergent views of parties concerned with the operation of the bankruptcy system; (3) evaluate the advisability of proposals with respect to such issues; and (4) prepare a report to be submitted to the President, Congress, and Chief Justice not later than two years after the date of the first meeting.

A 1,300-page report was submitted on October 20, 1997. Included in the recommendations are provisions that would provide Article III status for bankruptcy judges, allow direct appeals to the courts of appeal from the bankruptcy courts, and fast track scheduling for small business Chapter 11 cases. The report can be viewed in its entirety at the Web site address for the Commission, which address is www.nbrc.gov.

IS YOUR COLLATERAL COVERED?

A Georgia court has considered whether an insurance company has a duty to inform the insured and the mortgage holder of the lapse of a standard fire insurance policy due to nonpayment of premiums by the insured. The courts concluded that the relevant Georgia statute only requires such a notice when the insurance company refuses to renew the policy. No notice to either the insured or the mortgage holder is required where the policy lapses due to nonpayment.

Inside...

SHAREHOLDER HELD LIABLE FOR CORPORATE DEBTS.

When can an individual shareholder be held liable for the debts of the corporation in which he or she holds shares? Corporate creditors often seek to "pierce the corporate veil" by demonstrating that corporate formalities were not properly observed. In a recent decision, the Georgia Court of Appeals affirmed a jury's verdict in favor of such a creditor. The most damaging evidence against the shareholder was evidence that the

shareholder had other corporations and, when needed, money would be transferred between the separate businesses without documentation. Also damaging to the corporation was evidence that the corporation has used its funds to improve property which was owned by a partnership.

WRONGFUL FORECLOSURE FOR FAILING TO PROPERLY DOCUMENT TRANSACTION.

The Georgia Court of Appeals has affirmed a jury verdict for $350,000.00 on a claim for wrongful foreclosure. The controversy concerned a second loan that had been granted to pay off a first loan. The first note had been secured by a security deed on a home under construction. When the individual executed a second note with the same lender, the lender failed to have the borrower execute a second security deed. After execution of the second note, the individual received from the bank the first note and the security deed, both of which had been stamped paid. The Court of Appeals reversed the trial court's dismissal of the real property owner's claim for punitive damages. The Court of Appeals held that the jury should be allowed to decide whether to award punitive damages.

GEORGIA COURT DISAGREES WITH FEDERAL COURT WITH RESPECT TO INTERPRETATION OF EQUAL CREDIT OPPORTUNITY ACT.

A federal court of appeals ruled that the Equal Credit Opportunity Act ("ECOA") may provide a defense to a claim on a guaranty by a financial institution seeking to recover against the spouse of the borrower on the debt which was guarantied. A violation of the ECOA may be raised as a defense in actions to collect on a guaranty, the court reasoned. Otherwise, the statutory protection intended by Congress would not protect against the discrimination that ECOA is designed to prevent. The Georgia Court of Appeals, in a recent opinion, expressly disagreed with the federal appellate court, finding its reasoning unpersuasive.

ATTORNEY-CLIENT PRIVILEGE NOT ALWAYS ABSOLUTE.

The Georgia Court of Appeals has held that an attorney could be compelled to produce documents evidencing communications between himself and his client for in camera inspection by the Judge, even though the documents would otherwise be subject to the attorney-client privilege, if the facts necessary to show the presence or absence of privilege may be determined only by a review of the documents. The case involved letters and memoranda between a claims adjuster and counsel for the insurer. The documents concerned their attempt to evade a judgement against an insured by obtaining a release and settlement of the insurer's coverage liability from the insolvent and defunct insured for an amount which was nominal in comparison with the amount of the judgement. The ruling may be applicable in other situations, including cases in which a creditor alleges that counsel for the debtor assisted the debtor in planning a fraudulent conveyance of property.

BUSINESS DEBTOR DOES NOT HAVE JURY TRIAL RIGHT FOR LENDER LIABILITY ACTION.

A bankruptcy court in Georgia has ruled that a business debtor in Chapter 11 does not have a right to a jury trial with respect to a lender liability action against a bank. According to the court, the claim was legal in nature, not equitable. However, the plaintiff-debtor subjected its lender liability action to the equitable powers of the court by filing it in the bankruptcy court. Accordingly, the business debtor effectively waived its right to trial by jury in the adversary proceeding brought in the bankruptcy court.

ATTORNEY HELD LIABLE.

A federal court of appeals has held that a collection letter violated the Fair Debt Collection Practices Act ("FDCPA"), as it failed the "least sophisticated consumer" test in effect in the Eleventh Circuit. The defendant corporation violated the FDCPA by falsely representing that a form collection letter was sent by an attorney, when, in fact, it was sent by the defendant corporation. The attorney who prepared, but did not sign, the letter was also found liable under the FDCPA.

JUDGMENT HELD VOID.

The Georgia Court of Appeals has held that actions taken in violation of the automatic stay of the Bankruptcy Code are void ab initio. Thus, a judgement taken by a lender foreclosing on a debtor's property is void, without effect, and an absolute nullity. As such, it is not necessary for the bankruptcy court to issue an order declaring the foreclosure to be void prior to the initiation of a state court action.

CHANGES TO BANKRUPTCY CODE PROPOSED.

Two bankruptcy bills were introduced in the House of Representatives. One of the bills, the Bankruptcy Technical Corrections Act of 1997, would (i) clarify that a debtor's attorneys may be compensated out of the debtor's estate, (ii) more clearly specify the types of professional services that are eligible for administrative expense treatment, and (iii) allow nonindividuals to raise damage claims arising from violations of the automatic stay. The second bill, the Single Asset Bankruptcy Reform Act of 1997, would eliminate the $4 million ceiling on single asset real estate filings.

DESPITE FEDERAL STATUTE, PRIOR PERFECTED LIEN CREDITOR HAS PRIORITY OVER IRS LIEN.

The Pennsylvania Supreme Court recently interpreted conflicting provisions of the United States Code concerning the priority of federal tax liens and concluded that government liens do not always take precedence over other creditors of an insolvent estate. The court interpreted two plainly inconsistent statutes: § 6323 of the Tax Code, which says that liens which are perfected prior to a federal tax claim win, and 31 U.S.C. § 3713, which says that a government lien takes priority over all other creditors of an insolvent estate. The court concluded that because the Tax Code provision was enacted more recently, Congress must have intended to change the law and noted that a different interpretation would frustrate legitimate commercial expectations. At least one district court has reached a contrary conclusion.

EARNED INCOME TAX CREDIT IS PROPERTY OF THE ESTATE.

A Kansas district court has held that a debtor's Earned Income Tax Credit, a federal subsidy to low income working people with children, should be included as property of the bankruptcy estate.

PUNITIVE DAMAGES FOR FRAUD NONDISCHARGEABLE IN BANKRUPTCY.

In an opinion consistent with a previous decision rendered by the Eleventh Circuit, the Third Circuit recently held that the nondischargeability provision of the Bankruptcy Code with regard to damages for fraud applies to punitive damage awards in fraud cases as well as compensatory awards. The court held that the debtor's argument that a punitive award is a separate punishment not to be included in nondischargeability of a debt "to the extent obtained by fraud" strained the structure of the statute and was contrary to the policy of providing relief only to "honest" debtors.

SUPREME COURT BARS NONATTORNEYS FROM REPRESENTING CORPORATIONS.

The Georgia Supreme Court has revised its controversial decision that banned nonlawyer corporate officers and agents from representing their corporations in court and court pleadings. At the last minute, in an end-of-term change of heart, the court amended and reissued its opinion to apply the ban only to courts of record, apparently excluding most magistrate courts, municipal courts, city courts, and administrative tribunals. Those courts handle the bulk of garnishments, dispossessory proceedings and small-claims actions, which means corporations can continue to evict tenants and deal with collections without hiring attorneys.

DIRT FOR DEBT: IS IT DOABLE?

A partnership in the farming business filed a Chapter 11 case and obtained bankruptcy court approval of a reorganization plan in which the partnership distributed to the secured lender a portion of the land securing the obligation in satisfaction of the secured debt. The bankruptcy court found that the value of the land being distributed was sufficient to cover the debt. The partnership was thereby attempting to substitute dirt for debt. On appeal, the Ninth Circuit Court of Appeals reversed and held that the "indubitable equivalent" required under the Bankruptcy Code was not satisfied with respect to the secured claim of the secured creditor under the facts of the case before it.

PENSION PLAN EXCLUDED FROM BANKRUPTCY ESTATE.

A federal court recently considered whether Chapter 7 bankruptcy debtors' ERISA qualified pension plans should be excluded from their joint bankruptcy estates. Although the debtors had complete access to the funds in the plan, the court concluded that, due to the fund's antialienation provision, it should be excluded from the estate.

INDIVIDUAL RETIREMENT ACCOUNTS PROTECTED FROM TRUSTEE.

The Eleventh Circuit has recently ruled that a debtor's interest in an IRA should be excluded from property of the estate. As a result, in a bankruptcy case the trustee may not recover the IRA proceeds for distribution to the debtor's creditors.

TAX LAW CHANGES.

Periodically, Lamberth, Bonapfel, Cifelli & Stokes, P.A. mails out a summary of tax law changes or tax planning information. If you would like to be included on the mailing list, please contact Carter Stout.

CANADIAN CORPORATION HELD SUBJECT TO U.S. BANKRUPTCY COURT.

A Canadian corporation filed a proof of claim in a bankruptcy case in a United States bankruptcy court. Later, the Trustee for the Debtor sued the Canadian corporation seeking the recovery of an allegedly preferential transfer. When the corporation contested personal jurisdiction, the court concluded that, by filing the proof of claim, it had submitted to the jurisdiction of the bankruptcy court for purposes of the preference action.

PITFALL OF MAILING NOTICES TO REPRESENTED CLAIMANTS.

According to one court, direct mailing of bankruptcy bar date notices to personal injury claimants, instead of their known attorneys, violated the creditors' due process rights. As such, the creditors were entitled to file proofs of claim after the bar date.

NEW FAST TRACK SMALL BUSINESS BANKRUPTCIES.

The 1994 amendments to the Bankruptcy Code modified the Chapter 11 plan and disclosure statement provisions in order to make Chapter 11 less cumbersome and less burdensome for small businesses. If a debtor with a business, other than owning and operating real estate, has debts of less than $2 million, that debtor may elect to be treated as a small business under the Bankruptcy Code. A debtor that elects to be treated as a small business has an exclusivity period of 100 days (rather than 120 days) after the filing within which to file a plan, and is required to file a plan within 160 days unless otherwise ordered by the court. The debtor can file a plan and solicit votes for its acceptance prior to approval of a disclosure statement, so long as a disclosure statement is conditionally approved by the court and mailed to the creditors at least ten days before the hearing on confirmation of the plan. The Code authorizes a court to combine the disclosure statement approval hearing with the hearing on confirmation of the plan.

NEW BANKRUPTCY EXEMPTIONS PROPOSED.

The National Bankruptcy Review Commission has issued an endorsement of a plan to establish mandatory, uniform federal exemptions for consumer bankruptcies. Under the proposal, a state's right to opt out of Bankruptcy Code exemptions would be eliminated, but there would be some leeway given to set the amount of any homestead exemption. The Commission also proposed to reduce the other categories to a single "other property" catch-all category of up to $25,000.00 in value of property in any form. The Commission argues that reducing the number of categories would eliminate most prebankruptcy planning and would prevent the gross abuses that persist in the current system.

AGREEMENT HELD NOT TO BE COLLUSIVE.

A Fulton County Superior Court judge has ruled that there is nothing improper about a foreclosing creditor reaching an agreement with a third party to finance the third party's bid at a foreclosure sale, so long as the agreement or understanding does not impact the amount of the sale price or otherwise chill bidding. The court ruled that it is not collusive bidding to agree with a third party bidder to finance the third party's bid, even if the lawyer announces at the foreclosure sale that payment is to be in cash. An agreement is considered collusive only if the agreement sets the bid price or otherwise results in a chilling of bids.

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