

# THE ROLE OF CERTIFIED PUBLIC ACCOUNTANTS IN BANKRUPTCY CASES

By: Robert L. Pryor<sup>1</sup>

## I. Overview

A. A certified public accountant plays a critical role in bankruptcy practice. He is an essential and critical member of the team necessary to administer a bankruptcy case. This is true in both Chapter 7 and in Chapter 11 bankruptcy cases.

B. Chapter 7. A Chapter 7 individual case involves the liquidation of an individuals assets. The individual filing for Chapter 7 relief, seeks to obtain a discharge, of dischargeable debts. In exchange therefor, he surrenders to the Trustee for the benefit of his creditors all of his non-exempt assets.

(1) A business entity such as a corporation or a limited liability company, is also eligible for Chapter 7 relief. However, a corporation does not obtain a discharge.

(2) Query: If a corporation does not obtain a discharge, why would it seek Chapter 7 protection? There are three reasons why a corporation might seek Chapter 7 protection.

(a) First, its officers and directors owe various duties, e.g. duty of

---

<sup>1</sup> Mr. Pryor is founder and a member of the firm of Pryor & Mandelup, LLP, located in Westbury, New York. Mr. Pryor served as law clerk to the Honorable Chief Judge C. Albert Parente in 1983 through 1984. Since 1984 he has been a member of the Panel of Trustees for the Eastern District of New York. He is the past Chairman of the Bankruptcy Committee of the Nassau Bar Association. He has lectured extensively in programs organized by the Nassau and Suffolk Academics of Law, New York State Bar Association, Internal Revenue Service Accountants Continuing Education Program, Nassau District Attorney Lecture Program, NCCAP, and various trade associations and professional groups. Mr. Pryor is also the author of various scholarly articles appearing in the New York Law Journal and Nassau Lawyer, and is a frequent contributor to the Newsday "Ask the Expert" column. Mr. Pryor can be reached at 516-997-0999.

loyalty, duty to protect assets for the benefit of creditors, etc., on behalf of the corporation. Thus, by filing a Chapter 7 petition, these individuals may limit their duties arising from their status as officers and directors. This may be important if they are seeking to start a new business and are concerned about claims that the new business represents a continuation of the old.

(b) The duty to preserve assets for the benefit of creditors can be met by the filing of a corporate Chapter 7. If assets exist at the point in time the business is going to be closed, an officer and director may be concerned that he will breach a duty to protect those assets for the benefit of creditors if he simply closes the corporation's doors and walk away. A Chapter 7 petition creates a mechanism where these assets can be liquidated and distributed for the benefit of creditors at no material expense to officers and directors.

(c) Duty of investigation. In the context of a failed business, it is commonplace for creditors to question whether there was self-dealing, diversion of assets or other malfeasance. The filing of a Chapter 7 case automatically triggers the appointment of a Trustee, appointed by the Court to represent creditors. The fact that a Trustee has been unable to find evidence of any malfeasance may be used by officers and directors as evidence that none has occurred.

C. Chapter 11. Chapter 11 is a procedure, available to both individuals and business entities, whereunder they maintain possession and control over their assets, and propose instead to first solve their business problems and second, to propose a plan to pay to their creditors at least what they would have received in a Chapter 7 liquidation. Such a Chapter 11 case could entail reorganization, or liquidation, or a combination of both.

## II. The Role of a Certified Public Accountant in Chapter 11 Cases

### A. Accountant to the Debtor and Debtor-in-possession.

- (1) All typical accounting functions continue in Chapter 11.
- (2) Additionally, Chapter 11 debtors-in-possession must file monthly operating reports. These reports are due no later than the 20<sup>th</sup> day of the month following the reporting period, thus, a January monthly operating report must be filed no later than February 20<sup>th</sup>.
- (3) A copy of a standard form operating report is annexed to the lecture materials. (This is a corporate monthly operating report. There are also individual monthly operating reports, single asset real estate operating reports, and small business operating reports.)
- (4) The consequences of failing to strictly comply with the time requirements in which to file an operating report can be nothing short of catastrophic. Section 1112(b)(4) allows a bankruptcy judge to convert to Chapter 7 or to dismiss a Chapter 11 reorganization for "(F) Unexcused failure to satisfy timely any filing or reporting requirement established by this title . . . "
- (5) Additionally, Section 1104(a)(3) now provides that if grounds exist to convert or dismiss the case, the court can instead appoint a Trustee to run the debtors business if it finds that such appointment is "in the best interests of creditors and the estate."

B. Disclosure Statement.

(1) Another principal responsibility of an accountant for a debtor-in-possession is to aid in the preparation of a disclosure statement. The disclosure statement, disseminated in connection with a plan of reorganization, is akin to a prospectus, and must contain "adequate information" sufficient to enable a creditor to make an informed judgment about the debtor's proposed plan of reorganization.

(2) Typically, a disclosure statement will contain projections, which constitute extrapolations from the debtor's Chapter 11 operating history as to its potential profitability, and thus, its ability to fund the monthly payments required under the debtor's plan of reorganization.

(3) Under Section 1121(d)(2)(A), the exclusive period for a Chapter 11 debtor to file a plan may no longer be extended past 18 months after the date of the filing of the bankruptcy petition.

C. Small Business Cases –

(1) A small business debtor, is someone, excluding a person who is primarily involved in the business of owning or operating real property, that has secured and unsecured debts as of the date of the petition in an amount not more than \$2,190,000.00.

(2) A small business debtor has more substantial reporting requirements, and there is an especially tailored small business monthly operating report which reflects those heightened requirements. A copy of a small business monthly operating report is annexed to these lecture materials.

(3) In a small business case, the debtor's period to file a Plan is limited to 300 days.

Thus, the debtor has only ten months to file a confirmable Plan in a small business case.

D. Creditors Committee – Under Section 1102 of the Bankruptcy Code, the U.S. Trustee has the power to appoint a representative group of creditors, denominated the creditors committee, which is the statutory representative of the creditor body in connection with its negotiations with the debtor of a plan of reorganization.

(1) The creditors committee is authorized by statute to retain its own attorney, and to the extent necessary, to retain its own accountant.

(2) Typically the role of the accountant for a creditors committee is to assist said committee in negotiating the plan of reorganization.

(3) Depending upon the case, it is sometimes necessary for the creditors committee accountant to engage in forensic analysis of the debtor's books and records.

### III. Representing a Chapter 7 Trustee

A. As has been discussed, the filing by an individual or a corporation of a Chapter 7 bankruptcy case automatically causes the appointment of a Chapter 7 Trustee to administer the assets of such estate.

(1) Typically, the Chapter 7 Trustee's efforts to generate a bankruptcy estate include an investigation into the debtor's affairs, and a determination as to whether the debtor possesses claims against third parties, which the Trustee may then pursue for the benefit of the estate.

(2) Additionally, the Trustee is allowed to step into the shoes of creditors and to

pursue any claims they may have under applicable non-bankruptcy law to recover assets transferred by the debtor.

(3) Finally, the Trustee is granted specific statutory powers to avoid (reverse) transfers under various specific provisions of the bankruptcy code.

(4) The Trustee is authorized to retain professionals, including accountants.

B. The two most common avoidance actions commenced by a Chapter 7 Trustee are:

- a. Avoidable Preferences (11 U.S.C. § 547)
- b. Fraudulent Conveyances (11 U.S.C. § 548)

C. A preference, in layman's terms, is a repayment of a past due obligation which has the effect of preferring one creditor over the remainder of the creditor body. If the transfer is to an insider, the look-back period is one year before bankruptcy. If it is to a non-insider, the look-back period is limited to 90 days prior to bankruptcy. 11 U.S.C. § 547(b) defines a preference as follows:

(b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property –

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made –

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the

petition, if

(5) that enables such creditor to receive more than such creditor would receive if –

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made;

and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

D. Additionally, there are a series of statutory defenses to a preference cause of action, with which an accountant conversant with a Trustee's avoidance powers should be familiar. These defenses, set forth in 11 U.S.C. § 547(c) include:

- a. The contemporaneous exchange defense;
- b. The ordinary course of business defense; and
- c. The new value defense (the actual text of 11 U.S.C. § 547(c) is included in the lecture materials.

E. Fraudulent Conveyances. There are two independent sets of fraudulent conveyance statutes.

(1) Article 10 of the New York Debtor and Creditor Law contains a series of independent fraudulent conveyance statutes, which a Trustee may utilize to set aside transfers by the debtor, within a prescribed period of time, that result in the diminution of the debtor's estate.

(2) Similarly, 11 U.S.C. § 548 is an independent bankruptcy fraudulent conveyance statute.

(3) Under 548(a)(1) the Trustee may avoid transfers by the debtor that occurred within two years before the filing of the bankruptcy petition: a) if the debtor made such transfer with actual intent to hinder, delay or defraud then existing or future creditors, or b) where the debtor received less than reasonably equivalent value in exchange for such transfer, and c) (i) was insolvent on the date of the transfer, or (ii) was engaged in business or a transaction for which any property remaining was an unreasonably small capital or (iii) intended to incur or believed that the debtor would incur debts beyond its ability to pay as they matured.

#### **IV. Compensation of Accountants.**

- A. Retention—An accountant is a professional who must be retained by order of the court to properly represent the Trustee in bankruptcy, a debtor or debtor-in-possession in Chapter 11, or a creditors committee (11 U.S.C. § 327).
- B. To retain an accountant, a Trustee or debtor-in-possession or creditors committee must file an application with the bankruptcy court asking for preapproval of the retention, which application should be supported by an affidavit of the accountant meeting the statutory requirements. There must be an order signed by the bankruptcy court in advance of the performance of services (post petition) authorizing the accountant to so represent the party in interest.
- (1) The accountant's affidavit in support of the application must represent that the accountant does "not hold or represent an interest adverse to the estate, and that [he is a] disinterested person.
  - (2) A 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 two (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, in connection with, or interest in, the debtor or for any other reason.”

- (3) Thus, if an accountant holds a pre-petition claim, he is not a disinterested person, and is ineligible to serve as accountant to the bankruptcy estate.
- (4) Thus, an accountant may have to waive his pre-petition claim to be eligible to represent the bankruptcy estate. In re Eastern Charter Tours, Inc., 167 B.R. 995 (Bankr. M.D. Ga. 1994), In re Pica Systems, Inc., 124 B.R. 30, 33 (E.D. Mich. 1991).
- (4) A professional retained by order the bankruptcy court may not receive any compensation except with the approval of the bankruptcy court. In order to receive compensation, the professional must make an application for compensation. Such application must be served on all creditors and parties in interest, and the applicant must attend a hearing before the bankruptcy court to substantiate his entitlement to fees and must request the entry of an order approving said application.
- (5) Section 331 of the Bankruptcy Code provides that interim compensation may be approved by the Court, i.e., compensation prior to the disposition of the entire case. However, one may make an application for interim compensation not more than once every 120 days after the filing date.

Even where an application for interim compensation is granted, it is often customary to provide for a holdback. a holdback is a certain percentage of the total compensation granted which the court directs that the debtor hold and not pay to the professional until the completion of the case. The most customary holdback is a 25% holdback, although in certain cases, the courts have provided for much greater holdbacks, depending upon the court’s assessment of the potential for success of the case.

V. **Forensic Accounting.**

- A. Because of the nature of the proceeding, it is quite common that Trustees and creditors committees oftentimes require a forensic accounting analysis.
  
- B. One of the principal themes that run through all bankruptcy cases is that while honest debtors get rehabilitated, dishonest debtors and their principals do not obtain protection from the court. There are always issues as to what caused the problems besetting the debtor, and whether they are in any part caused by fraud, wrongdoing or other acts of malfeasance or misfeasance. Thus, it is customary that the Trustee and/or creditors undertake an analysis in the appropriate case to determine the facts giving rise to the case, whether any assets were dissipated in a manner in which they can be recovered, and whether any related person is answerable to returning assets to the debtor for the benefit of the creditor body.
  
- C. Among the causes of action most commonly pursued by a Trustee are alter ego actions, claims against officers and partners for breach of fiduciary duty, lender liability claims, substantive consolidation claims and professional malpractice claims.