Death, Divorce, Disaster & Divestiture

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Today’s Discussion

What are the legal and practical effects of the following events on a creditor’s rights and remedies?
• Death
• Divorce
• Disaster
• Divestiture

This presentation will focus on general state law, with an emphasis on Missouri and Illinois.

*Remember: each state’s property laws differ.*
Death

• Your customer, a sole proprietor, passes away unexpectedly. You are owed $100,000 for goods supplied to the customer before his death. What are your options for recouping your losses?

• First, it is important to note that creditor claims are not discharged by virtue of the debtor’s death.

• However, your ability to assert a claim against the deceased customer’s estate – and your ability to collect – will largely be dependent on your customer’s available assets, and whether he took steps before his death to protect his assets from creditors.
Death

• Under general probate law, upon a debtor’s death, the debtor’s assets and liabilities are marshaled – used first to pay creditors, with any excess distributed to the heirs of the debtor’s estate.

• Missouri law provides that claims and family allowances shall be paid by the estate representative before heirs and devisees can receive distributions.

• If there are not sufficient assets to pay all claims and allowances, they are paid in proportion by certain priority classifications:
  – Costs of administering the probate estate come first, followed by exempt property, family and homestead allowances, funeral expenses, debts due the United States, the state, and any other political subdivision, judgments, and then all other claims not otherwise barred.
Death

• Missouri law provides that all claims against the estate of a deceased person must be filed in the probate division of the circuit court:
  – Within six months after the first published notice of letters testamentary or of administration; or
  – If notice was actually mailed to, or served upon, such creditor, within two months after the date such notice was mailed, or served, whichever later occurs

• A failure to timely file a claim with the probate division results in the claim being forever barred against the estate, the estate representative, and the heirs of the decedent.
Death

- A valid claim must be in writing and sufficiently describe the basis for the claim. The probate court has forms that can be obtained by the claimant.
- It must be signed by the claimant, or by some person for him who has knowledge of the facts, stating that to the best of his knowledge and belief he has given credit to the estate for all payments and offsets to which the decedent was entitled.
- If the claim is based on a contract or other writing, copies of those writings should be filed with the claim.
Death

• In order to avoid probate, many individuals will engage in asset protection activities prior to their death, including through the creation of asset protection trusts.

• Missouri law permits the creation of an Asset Protection Trust, which is an irrevocable trust that allows an individual to transfer their assets into the trust, retain the ability to be a beneficiary of the trust and retain certain powers and controls over the trust.

• When properly structured, these trusts provide the debtor with protection from future creditors and bankruptcies.
Death

• However, you may have certain rights and remedies even if your debtor created an Asset Protection Trust.

• Importantly, an Asset Protection Trust is not valid if the transfer of assets to it are a transfer in fraud of creditors.
  – Debtor cannot transfer *all* of its property into the trust, thereby rendering it unable to pay its bills
  – Trust cannot be funded for the purpose of avoiding current creditor claims or reasonably foreseeable claims.
  – Asset Protection Trust can be completely set aside for a period of four years from the date of transfer.
Death

• What about if the decedent is a personal guarantor?
• If the guaranty secures a debt not yet due, the creditor holding the guaranty has only a contingent claim, which may not be paid before the distribution.
• If the guaranty has already triggered, the creditor may file a claim with the probate court and participate in distributions along with other creditors.
• Under most states’ laws, the death of the guaranty may terminate liability under the guaranty for loans borrowed after the date of death.
  – As a result, death of a guaranty is usually included as an event of default in standard loan documents.
Death

• What about if you are engaged in pending litigation against a debtor that passes away?
• Under both state and federal law, so long as the death does not cause an extinguishment of the claim being litigated, it is critical that you seek to move for substitution of the estate representative as the defendant.
  – Generally, such motion must be filed within 90 days after notice of the decedent’s death is served.
You hold a judgment against Mrs. Smith on account of a personal guaranty she made to you for business debts of ABC Corp., of which she is a major shareholder.

Her spouse, Mr. Smith, is not an ABC shareholder and did not guaranty its obligations to you.

Mr. and Mrs. Smith commence divorce proceedings in St. Louis.

What are your rights vis-à-vis the marital property of the Smiths?
Divorce

• Your rights as to marital property will largely be dependent upon whether the state of residence of the debtor is a “community property” state or a “equitable distribution” state
Divorce

• Community property states
  – In community property states, the courts consider debt incurred during the marriage as the debt of both spouses, regardless of whether both spouses’ names were on the debt.
  – Spouses’ creditors cannot get at property brought to the marriage but kept truly separate from the spouse; hence, creditors can only assert claims against property generated during the marriage.
  – Upon a divorce, community property states split debts 50/50 among the spouses.
Divorce

• Equitable distribution states
  – All other states (including Missouri and Illinois)
  – In an equitable distribution state, courts divided marital debt equitably so spouses are generally only responsible for the debt they incurred. Similarly, assets are divided equitably, such that property acquired during the marriage belongs to the spouse who earned it
    • If the debt was incurred on a joint credit card or loan, both spouses would split that debt in a divorce.
      – Joint debts can be enforced against either spouse, such that if one spouse cannot (or refuses) to pay, the entire debt can be enforced against the other spouse
    • If just one spouse took on the debt, only that spouse would be responsible for it in a divorce.
Divorce

• Is a potential solution to demand that the other spouse provide a guaranty? In Missouri, probably not.

• Under the Equal Credit Opportunity Act, Missouri recognizes an affirmative defense for spouses who sign personal guarantees for loans made for their spouse’s business.

• ECOA prohibits creditors from discriminating against any applicant for credit on the basis of marital status.
  – This prohibition has been interpreted to mean that a creditor cannot require the signature of an applicant’s spouse on any credit instrument if the applicant otherwise qualifies under the creditor’s standards of creditworthiness.
  – However, consider whether the signature can be required if the applicant does not otherwise qualify for credit.
Disaster

• One of your largest customers, XYZ LLC, purchased 10,000 cases of widgets from you, at a total cost of $1 million, on net 60 day terms.
• You shipped the widgets on September 1, arriving at XYZ’s warehouse in Mendocino, California on September 5.
• On September 7, disaster strikes! The wildfires that have engulfed much of the Western United States spread to Mendocino, destroying XYZ’s warehouse (not to mention all of your inventory).
• What are your options?
As an initial matter, the destruction of the inventory does not extinguish XYZ’s liability to you. Accordingly, you may continue to enforce your claim against XYZ based on agreed-upon terms.

- However, along with the destruction of the inventory, XYZ may also have lost the ability to pay.
- To the extent that you are party to a written agreement with XYZ, you should insist that XYZ maintain adequate insurance coverage to mitigate risk of loss from fire or other destruction of property.
Now, what if you had not sold the goods, but rather, consigned them to XYZ?

- Under a consignment, title to inventory does not pass until the consignee sells it to its end customer
- Accordingly, at the time of the fire, you continued to be the owner of the goods and now incur the risk of loss
- In a consignment relationship, it is therefore critical that you have, in your consignment agreements, an agreement by the consignee (XYZ) to maintain adequate insurance coverage on the consigned goods
- Moreover, you should insure that your company’s insurance policies similarly provide coverage for consigned goods.
Disaster

• Now, what if the widgets had not yet arrived at XYZ’s warehouse, but rather, were in transit, and the tractor-trailer carrying them (and your goods) were destroyed in transit?
• The risk of loss will depend on the shipping terms agreed to by the parties:
  – If goods were shipped FOB shipping point or FOB origin, the sale was considered complete at your shipping dock, meaning that ownership (and risk of loss) passed to the buyer. Hence, it would be the buyer’s responsibility to pay for the shipment (or to make a claim against its insurance or the freight carrier’s insurance)
  – If goods were shipped FOB destination, the sale is not complete, and title does not transfer, until arrival at XYZ’s warehouse. Hence, the risk of loss would fall to you.
• It is critical that you ensure that any shippers used to deliver your goods (regardless of the FOB terms) are properly licensed and insured.
Divestiture

• You have been doing business with Supercorp for about 5 years. They have generally been a good customer, generally paying your bills within terms. Supercorp generally orders about $100,000 per month of goods from you.

• One day, a purchase order comes across your desk for $500,000 of product, an unusual number for Supercorp. You call your contact there, who informs you that they have had a spike in orders and desperately need more inventory.

• Seeing as Supercorp has not given you cause for concern in the past, you decide to authorize the order.
Divestiture

- After you have produced and shipped the goods, you get a letter from Supercorp, announcing that they have gone out of business and liquidated its assets.
- What are your options?
Divestiture

• First, you should demand an accounting from Supercorp as to the proceeds of its liquidation and the whereabouts of your inventory.
  – If the inventory is still in Supercorp’s possession, you may have rights under state law to reclaim the inventory
  – If the inventory has been sold:
    • If the purchaser was a bona fide purchaser for value, you likely do not have recourse against the purchaser
    • However, if the purchaser was not a bona fide purchaser (i.e., someone that had knowledge of your claim to the property, or an insider), you may be able to assert a claim against the purchaser for the value of the inventory improperly transferred.
    • Furthermore, you may be able to assert a fraudulent transfer claim against the purchaser, the outcome of which would be to bring the property, or its value, back into Supercorp for distribution to creditors.
Divestiture

• Second, you should consider whether you have claims against the insiders of Supercorp

• If it is determined that Supercorp willfully built up inventory in order to liquidate it for the insiders’ benefit, you may be able to assert a breach of fiduciary duty claim against those insiders, allowing you to reach the insiders’ personal assets (or the value of any directors’ and officers’ liability insurance in place)

• In other circumstances, you may be able to “pierce the corporate veil” to get at the assets of the insiders
  – This will generally require proof that there is no real separation between the company and its owners, or that the company’s actions were wrongful or fraudulent
Divestiture

• Third, you may wish to consider filing an involuntary bankruptcy against Supercorp
  – Section 303 of the Bankruptcy Code requires that, if there are 12 or more creditors, three creditors, having noncontingent, undisputed unsecured claims in the aggregate of $15,325, must file the involuntary petition
  – Supercorp would then have an opportunity to answer, or seek to dismiss the involuntary petition, on grounds that it is solvent, or that the petition was filed in bad faith (i.e., for purposes of harassment)
  – Benefits of an involuntary bankruptcy
    • Supercorp will have to disclose all of its assets and liabilities, as well as any transfers of its property within two years of the bankruptcy
    • A trustee will be appointed that can investigate and prosecute fraudulent transfer claims, or other claims against Supercorp’s insiders. This investigation comes at no direct cost to the creditors.
    • May result in enhanced creditor recoveries.
Divestiture

- What if you learn that the business was sold to a third-party in order to avoid paying creditors?
  - You may have a “successor liability” claim against the purchaser.
  - Under Missouri’s corporate continuation doctrine, a court will hold a successor business liable for obligations of a previous business by weighing the following factors:
    - Whether there exists a common identity of officers, directors, and/or shareholders
    - Whether the new business continued in the same business as the previous business
    - Whether the labor force is substantially the same
    - Whether the assets and liabilities of the previous business were acquired or utilized by the new business
    - Whether there is commonality between customers and/or vendors
Divestiture

• What if you learn that the business was sold to a third-party in order to avoid paying creditors?
  – In addition, if the sale of the business was in furtherance of a scheme to hinder, delay or defraud creditors, or was for less than fair value, a creditor may be able to assert a fraudulent transfer claim against the purchaser.
  – In that event, the fraudulently transferred assets, or their economic value, may be returned to Supercorp for satisfaction of creditor claims.
  – An involuntary bankruptcy filing is also an option.
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Questions or Comments?