

DEBTOR/CREDITOR

January 2012

President Can't Stiff his Company

Dave Harwood was president of B&W Finance Co. B&W was the corporate general partner of FNFS, a limited partnership. Dave managed the affairs of FNFS. Between 1997 and 2004, Dave borrowed more than \$800,000 from FNFS for his personal use. Although he documented these loans by giving FNFS a promissory note and mortgages, he did not have FNFS record the mortgages.

Dave was forced out of B&W in April 2005, and filed a Chapter 7 case in June 2005, after FNFS sued him to collect the loans. His attempt to discharge his obligation to repay the loans through a bankruptcy was unsuccessful. A federal appeals court in New Orleans upheld the bankruptcy court's decision to deny Dave a discharge from the loans.

The court reasoned that Dave had fiduciary duties to FNFS, due to B&W's duties to FNFS as general partner, and his duties to B&W as its president. In order to protect FNFS's interests, Dave should have followed a normal lending practice of recording the mortgages that secured the loans. The court held that Dave's failure to record the mortgages constituted "defalcation while acting in a fiduciary capacity," which prevented the discharge of his debt to FNFS.

FNFS, Ltd. v. Harwood (In re Harwood), 637 F.3d 615 (5th Cir. 2011).

Employees Get Severance Pay

Courts have long been divided regarding how to treat severance pay in a bankruptcy case. Because most severance pay is determined by the number of years that the employee has worked for the company, some courts have reasoned that severance pay is an old company obligation which accrues over time. As an old debt of the company, it should be paid pro rata with general debts.

Other courts have reasoned that severance pay is a new debt which only arises when the employee is terminated – just before or even after the filing of the company's bankruptcy case. As a new debt incurred as part of the bankruptcy restructuring process, severance pay should be entitled to priority of payment over other debts.

In a recent decision, the federal appeals court covering the state of Maryland has joined the latter camp. Employees terminated after a bankruptcy or within 180 days prior will have a priority of payment for their severance.

Matson v. Alarcon, 651 F.3d 404 (4th Cir. 2011).

No Protection Against Preferences

In its mortgage documents, Bank wrote a provision stating that even after the debt was paid in full "this Mortgage shall continue to be effective or shall be reinstated" if any of the loan repayment was subsequently recovered by a bankruptcy trustee as a preferential transfer. Bank argued that this provision excused it from releasing its mortgage when Borrower made full payment, because Borrower's shaky financial situation created a risk that a bankruptcy trustee might, in the future, recover some of the payment as a preference. The court disagreed, reasoning that Bank could not cloud title to the property on the basis of speculative future events.

Dixon v. Gluth (In re Gluth Bros. Construction Co.), 451 B.R. 447 (Bankr. N.D. Ill. 2011).

○ ○ ○

This newsletter is intended to inform its readers of developments in the area of debtor/creditor relations. It is not legal advice or a legal opinion regarding any specific matter. You should consult a lawyer regarding any questions relating to your particular situation.

Prepared by James C. Olson, Attorney and Counselor at Law