PART VI

BANKRUPTCY

Chapter 17: Bankruptcy Code Proceedings

Chapter 18: Bankruptcy Alternatives

17 Bankruptcy Code Proceedings

Overview

The term **bankruptcy** comes from Latin and means *"broken bench."* Originally, when a merchant failed to repay suppliers in a timely manner, the suppliers would break the benches that displayed the goods of the merchant. With a broken bench, that merchant was unable to conduct business. Today, bankruptcy is far more complex and is governed by federal law. This chapter presents the general basics of bankruptcy. As with all legal issues, credit professionals are urged to seek legal counsel.

THINK ABOUT THIS

Q. What are the most important factors to ensure the business receives payment when a customer files for bankruptcy?

Q. What steps can a creditor take to mitigate risk exposure if the possibility of a bankruptcy exists?

Q. After learning a customer has filed for bankruptcy, what steps should a creditor take?

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- The automatic stay provisions of the Bankruptcy Code.
- Chapters 7, 11, 12 and 13 of the Bankruptcy Code.
- How to establish a response to bankruptcy filings.
- How to pursue claims.
- How the Office of the U.S. Trustee works.
- The basic recovery procedure.

Chapter Outline

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Bankruptcy Code History and Summary

The **Bankruptcy Code,** found in Title 11 of the United States Code, *is the federal law that provides an organized procedure under the supervision of a federal court for dealing with insolvent debtors.* The Bankruptcy Code was adopted in 1978 and became effective on October 1, 1979. The 1978 Code was the first substantial revision of the bankruptcy laws in effect in the United States. Prior to 1979, the **Bankruptcy Act of 1898** (or the **Bankruptcy Act**) was in force. *Although the 1898 Act allowed for individual bankruptcy filings, it was primarily a business law for the winding down of failed businesses.* The **Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)**, enacted on April 20, 2005, became generally effective on October 17, 2005. While many of the provisions of the BAPCPA address consumer and individual bankruptcies, the BAPCPA also affects corporations, small businesses and farmers, and deals with multinational debtors.

The Code consists of nine chapters. The first three chapters, **Chapters 1, 3** and **5,** *contain administrative provisions that apply in all cases under the Bankruptcy Code.* The remaining six chapters, **Chapters 7, 9, 11, 12, 13** and **15** *are the operative chapters for filing different types of bankruptcies.* The threshold amounts in the chapters are periodically adjusted for inflation.

Chapter 7 *is a liquidation bankruptcy,* sometimes called a straight bankruptcy, in which a trustee is appointed by the United States Trustee in every case to liquidate nonexempt assets.

Chapter 9 *pertains to municipalities and governmental units.* A Chapter 9 bankruptcy can only be filed on a voluntary basis.

Chapter 11 *is the business reorganization chapter.* Most Chapter 11s involve a debtor in possession of assets who is attempting to rehabilitate a business. A small business may reorganize under an expedited Chapter 11 proceeding. A small business is defined as a business with total debts of less than $2,566,050.

Chapter 12 *is commenced only by a voluntary petition by family farmers who have debt up to $4,153,150 and family fishermen who have debts up to $1,924,550.* There are also set percentages of the debt which must have arisen from the operation of the family farm or fishing operations (50 percent for farmers and 80 percent for fishermen) while in each instance, 50 percent of the annual gross income must have been derived from the farm or fishing operation. The purpose of Chapter 12 is to provide family farmers and family fishermen with a chance to reorganize debt and retain their assets.

Chapter 13 *is sometimes called the wage earner's plan. Any individual with regular wages or income is eligible to file under Chapter 13, including certain professionals or business owners.* The threshold limits for a debtor to be eligible to file are $394,725 for unsecured debts and $1,184,200 for secured debts.

Chapter 15 *provides mechanisms to deal with multi-national insolvencies.* It is intended to establish cooperation among U.S. courts, trustees and debtors and their foreign counterparts.

One of the most important things to know about the Bankruptcy Code is that adherence to deadlines is critical; noncompliance can affect a creditor's rights under the law.

Comprehension Check

Provide a brief definition of the following chapters of the Bankruptcy Code: **7, 9, 11, 12, 13 and 15.**

Federal Rules of Bankruptcy Procedure

Congress has empowered the Supreme Court to adopt rules of procedure for bankruptcy cases, called the **Federal Rules of Bankruptcy Procedure.** There are nine chapters of rules containing deadlines and other regulations that govern pleadings, motions, practice and procedures in the bankruptcy court. They also provide for the Bankruptcy Courts and the United States District Courts to adopt local rules. If there is a conflict between the provisions of the Bankruptcy Code itself and the various applicable rules, the Bankruptcy Code prevails.

The Automatic Stay

The filing of a bankruptcy petition imposes an **automatic stay** *which is an injunction that halts actions by creditors, with certain exceptions, to collect debts from a debtor who has declared bankruptcy.* These actions include:

- Beginning or continuing judicial proceedings against the debtor.
- Obtaining possession of the debtor's property.
- Creating, perfecting or enforcing a lien against the debtor's property.
- Setting off indebtedness owed to the debtor that arose prior to the bankruptcy proceeding.

The purpose of an automatic stay is to ensure a fair distribution of the debtor's nonexempt, unencumbered assets among creditors. It prohibits any action to collect the debt from the debtor or the debtor's property. Governmental agencies, such as the IRS, cannot seize or file liens against the assets of the debtor without permission of the Bankruptcy Court. Generally, creditors cannot offset credits or returns against the debtor's debt. Any violation of the stay is in contempt of court and may be punishable by fines and fees.

A creditor may seek permission of the court to lift, terminate or modify the automatic stay if that creditor can show cause. One reason to lift the automatic stay is a lack of adequate protection of an interest in property. The creditor must show that the debtor does not have any equity in such property and such property is not necessary for a successful reorganization. In order to lift the automatic stay, the creditor must file a motion for relief from the automatic stay. Usually a filing fee is required. In routine Chapter 7 consumer cases, motions rarely have hearings; complex Chapter 11 cases almost always do. An unsecured creditor seeking to lift the automatic stay should consult with counsel upon receipt of the bankruptcy filing.

Comprehension Check

What is the purpose of an **automatic stay** in bankruptcy?

*What Happens When the Owner Goes Bankrupt?**

A mechanic's lien serves as a powerful tool for contractors, subcontractors and materials suppliers to secure payment for their work, labor or supplies. The lien, placed on real property, is based on the value added to the property during the construction process. It gives claimants the ability to force a sale of the property to obtain funds necessary to pay the delinquent debt, said William Porter, Esq., a principal in the Porter Law Group, Inc., based in Sacramento, CA.

Mechanic's liens holders file against property owners of a project as protection against not getting paid by a general contractor or subcontractor. But what happens if the property owner files for bankruptcy?

The owner/developer's bankruptcy does not automatically negate a mechanic's lien, said Wanda Borges, Esq., principal of Borges & Associates, LLC, in Syosset, NY. "A mechanic's lien gives a creditor a good position because it has an interest in the debtor's property. It's secured debt and has a greater chance of being paid in a bankruptcy proceeding. That lien will stay intact." A mechanic's lien also is not subject to preference payment rules because the creditor has that legal right to file, Borges added. Mechanic's liens are statutory liens and as such are unavoidable in a bankruptcy proceeding and will survive the bankruptcy unaffected.

Secured creditors hold significant advantages over unsecured creditors in nearly all bankruptcy cases, Borges said. A holder of a valid mechanic's lien is treated as a secured creditor and entitled to full payment, provided that the property securing the lien has value in excess of prior liens and encumbrances.

Perfecting the Lien

Being able to perfect and enforce mechanic's liens is important in bankruptcy. "Ideally, a contractor, subcontractor, or supplier does so before the owner files bankruptcy," said law firm Fabyanske Westra Hart & Thomson, out of Minneapolis, MN, in a briefing paper on its website. "If a party properly perfects its mechanic's lien pre-bankruptcy, the lien will typically 'pass through' the bankruptcy unaffected." Despite the bankruptcy, the mechanic's lien holder must still perfect its lien within the time provided under state law.

"Even if a creditor hasn't filed at the time of the bankruptcy filing, it can still file that lien," Borges said. "The circumstances vary state by state." The mechanic's lien is treated as any other secured claim.

"In a Chapter 7 case, this means that the full value of the lien claim remains in place if the property has sufficient unencumbered value to satisfy the entire claim," FWH&T said. "In a Chapter 11 case, the rights of a mechanic's lien claimant may be modified by the terms of the reorganization plan. If a lien is not perfected before the bankruptcy is filed, a claimant may be relegated to the status of an unsecured creditor, which are last in line, and only recover their claims if there is money left over after the secured creditors are paid."

If it's a Chapter 11, that means there's enough money in the company for it to operate, said Chris Ring, of STS. Then it's a reorganization of the business. The lien would likely stay intact as a secured creditor. However, if it's a Chapter 7, it could be stripped away because that involves liquidating assets.

The timing of lien filings matter, Ring said. "In some states, it's 'first in time, first in right.' It's all based on a state's statute." If a state follows the "first spade rule," all liens have an equal position based on when the project started and then it sometimes becomes a battle of who gets paid.

The Automatic Stay

A debtor's bankruptcy filing triggers the automatic stay, which halts collection or enforcement activities against the owner, via Bankruptcy Code Section 362(a). "Collection or enforcement activities include beginning or continuing litigation, any efforts to collect money, or unilaterally terminating or enforcing a contract," said Christine Barker, Esq., senior counsel with Gordon & Rees LLP, in Irvine, CA.

The stay prohibits a creditor from creating, perfecting or enforcing a lien against the debtor and/or property of the debtor's estate, said Bruce Nathan, Esq., partner with Lowenstein Sandler LLP. The code, however, prescribes certain exceptions. Under the law, mechanic's lien creditors whose lien arose prior to bankruptcy may perfect, maintain or continue the perfection of an interest in the property if, under state law and in the absence of bankruptcy, the creditor could have perfected or maintained its mechanic's lien, Nathan said.

State laws vary. For instance, in some, the lien arises at the start of the project. Typically, however, it's when materials are delivered or the work is performed—before a lien is perfected. For that reason, the Bankruptcy Code allows a mechanic's lien creditor who performed work and/or supplied materials prior to the filing of the bankruptcy petition to perfect or maintain the lien.

Enforcement

Exceptions pertaining to mechanic's liens, however, do not pertain to enforcement. Section 546(b)(1) does not deal with a creditor's post-petition enforcement of its mechanic's lien rights, Nathan said. That means the bankruptcy stay applies to a creditor's post-petition action to enforce its lien rights, and the creditor cannot take any post-petition action to enforce its lien unless it obtains a Bankruptcy Court order granting relief from the stay.

"The automatic stay does prohibit filing a lawsuit to foreclose on the mechanic's lien without first obtaining Bankruptcy Court approval," Porter said. "In addition, any state court lawsuit already on file against the bankrupt party is automatically stayed (or suspended) until the Bankruptcy Court grants relief to allow the plaintiff to proceed with the action. … State court lawsuits filed against a bankrupt debtor after the bankruptcy filing are void and of no effect."

If you have already filed a lawsuit to foreclose on your lien, this action is also paused by the automatic stay and all proceedings cease until the automatic stay is lifted, the bankruptcy is dismissed, or the property securing the mechanic's lien is abandoned, Barker said. If you have not yet filed a lawsuit to foreclose, the automatic stay prohibits you from filing suit at this time.

A mechanic's lien creditor may file a notice of continued perfection with the bankruptcy court to preserve its rights to enforce its lien against the property. Creditors can't do anything with a mechanic's lien unless they make a motion to lift the automatic stay and the court approves the motion, Borges said. If there's plenty of equity, the court could remove the stay. In that case, however, the debtor will likely try to work something out, she said.

The creditor could also petition the court for relief from the automatic stay. After the holder of the lien perfects it, enforcement of the lien may be tolled during the stay period until enforcement is possible. The holder can also petition the court to lift the stay.

Claimants must enforce mechanic's liens within a certain time period. Once the mechanic's lien claimant learns that the automatic stay is lifted, it should then proceed in state court with an action to foreclose its mechanic's lien, keeping in mind that it could lose its rights if it fails to act promptly, Porter said.

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Chapter 7 Liquidation

Chapter 7, the most common type of bankruptcy filing in the U.S, *is a straight bankruptcy or liquidation.* Most *Chapter 7 filings are consumer cases.* In all Chapter 7 cases, a trustee is appointed to take possession of nonexempt assets and sell them for the benefit of creditors. There are usually few, if any, nonexempt assets to sell.

In order to be eligible to seek Chapter 7 bankruptcy relief, an individual debtor must seek credit counseling within 180 days before filing a petition and pay a filing fee. Otherwise, the Chapter 7 will be dismissed. An individual Chapter 7 debtor must also satisfy a **means test** *where net income exceeds certain amounts* in order to proceed. If the individual Chapter 7 debtor cannot satisfy the means test, the case will be dismissed or converted to a Chapter 11 or 13. Once the case is filed, the U.S. Trustee appoints an **interim trustee,** *who is usually an attorney or an accountant assigned at random from a panel of qualified individuals.* The interim trustee has two main duties: to review the file and take possession of any unencumbered assets and to preside at the **Section 341 (§341) meeting** *which is the first meeting of creditors and equity holders.* Creditors may elect a different trustee at this meeting. There are legal qualifications and steps that must be followed. If no trustee is elected at the §341 meeting, the interim trustee's position becomes permanent. After the §341 meeting, the creditors cannot elect a new trustee, although the court may replace the trustee.

The trustee has several legal responsibilities:

- Sell any assets of the estate that are not encumbered or exempt for the benefit of the creditors.
- Investigate the financial affairs of the debtor.
- Investigate and examine proofs of claims of the creditors.
- In the rare instances when there are unencumbered assets, the trustee takes possession and prepares to liquidate them.
- Liquidate the assets and notify all of the creditors of the details in advance.

If a creditor has an interest in the property to be sold, such as a lease, consignment or secured position, that creditor must file an objection before the sale date. Objections are usually filed to ensure that the creditor's security interest in the sold asset will be recognized and, if the security interest is valid, that the creditor will receive the proceeds of sale. Without the filing of an objection, assets sold by the trustee are normally sold with clear title to the property and free of any liens.

Trustee's Compensation

Chapter 7 trustees are paid a small fee per case handled plus a percentage of the assets distributed to creditors. Compensation is so low that courts usually award the maximum compensation possible. Except for office overhead, trustees may be reimbursed by the estate for their expenses. Creditors are notified of intended payments to trustees and others and may file objections within the stated deadline in the notice.

Comprehension Check

What are the basic duties of a **trustee?**

Filing a Proof of Claim

In a Chapter 7 bankruptcy, a creditor must file **proof of claim form 410**, *which is used by creditors to indicate the amount of debt owed by the debtor on the date of the bankruptcy filing,* to participate in the distribution of estate

assets. By filing a proof of claim, a creditor may be waiving its right to a jury trial on certain preference and fraudulent transfer actions and submitting to the jurisdiction of the bankruptcy court for other purposes. It is prudent to discuss the filing of a claim with counsel unless it is certain that the debtor does not have a potential claim for fraudulent or preferential transfer or otherwise against the creditor.

Distribution of Assets

To close a case, the trustee files a final report with the court and with the approval of the U.S. Trustee when all the issues of a case have been settled and the trustee is prepared to distribute the funds. It is common practice for the trustee to notify the creditors of the recommended distribution of funds and their fees. If there are no objections, the final hearing is waived and the distribution is approved as stated in the notice. If a hearing is scheduled, the trustee is usually required to appear before the court. Written objections to the recommended distribution or to the tentative fees must be filed before the deadline given in the notice. The bankruptcy court then makes the final determination.

The trustees are required to satisfy claims in a particular order. The priorities are clearly established. Proceeds from assets are distributed in a sequence of priorities:

1. **Secured Creditors.** A secured creditor is entitled to have a first claim on proceeds from the sale of collateral assets. Any excess amount received from security is available to other creditors. Any deficiency in funds resulting from the sale of collateral makes the secured creditor an unsecured creditor for the amount of the deficiency. An additional first level priority claim is an allowed unsecured claim for domestic support obligations which are claims due to a spouse, former spouse, or child of the debtor, or such child's parent, legal guardian, or responsible relative.
2. **Administrative Expenses.** These are expenses related to the bankruptcy proceeding, such as professionals retained during the bankruptcy and the actual costs and expenses of preserving the estate. They also include claims for post-petition sales to a debtor in possession. This encourages creditors to extend new credit to a bankrupt business during a Chapter 11 proceeding. In addition, there is an administrative priority claim for the value of any goods received by the debtor, in the ordinary course of such debtor's business within 20 days before the date of commencement of a bankruptcy case that remain unpaid on the bankruptcy filing date.
3. **Involuntary Case Claims.** In an involuntary case, this is a claim arising in the ordinary course of debtor's business or financial affairs after the commencement of the case but before the earlier of the appointment of a trustee and the order for relief.
4. **Wages and Compensation Claims.** Wages earned within 180 days prior to a bankruptcy filing receive a priority claim limited to $10,950 per wage earner (subject to increase for inflation).
5. **Employee Benefit Plans.** These are unsecured claims for contributions to an employee benefit plan arising from services rendered within 180 days prior to a bankruptcy filing to the extent of $10,950 (subject to increase for inflation) multiplied by the number of employees covered by the pension plan less any amounts paid to the wage and compensation claims and less any amounts paid on behalf of the estate to any other benefit plan.
6. **Grain Producers or Fisherman Claims.** These are allowed unsecured claims of persons engaged in the production or growing of grain where the debtor owns or operates a grain storage facility, or a fisherman who has sold to a debtor who is engaged in operating a fish produce storage or processing facility.
7. **Customer Deposits.** A maximum of $2,425 per claimant (subject to increase for inflation) is available to individuals who place a deposit on property or services for personal, family or household use.

8. **Taxes.** Federal, state, country or any other type of government agency receives a priority.
9. **Unsecured Claims of a Federal Depository Institutions Regulatory Agency.** These are claims based upon any commitment by the debtor to a Federal depository institutions regulatory agency (or its predecessor) to maintain the capital of an insured depository institution.
10. **Claims Arising from the Unlawful Operation of a Motor Vehicle or Vessel.** These are allowed claims for death or personal injury resulting from the operation of a motor vehicle or vessel if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance.
11. **Unsecured Creditors.** These claims are often referred to as general creditors' claims. They include trade creditors, deficiency claims of secured creditors and debenture holders. A subordinated debenture also holds this type of claim but generally must turn over proceeds to the party to whom they have subordinated until the party is paid in full.
12. **Preferred Stockholders.** Preferred stockholders are paid after all creditors are paid in full.
13. **Common Stockholders.** Last in line are the common shareholders who bear the residual risk. Any remaining funds are paid to common stockholders after all other claimants are paid in full.

Trustees may not give creditors legal advice about the case. They are fiduciaries and hold the estate in trust for all the creditors. A creditor that has concerns about how a case is being handled has two options:

1. Retain counsel to object to the trustee's final report.
2. Contact the U.S. Trustee for the district in which the case is pending.

Monitoring the notices of sale and the notice of distribution is usually sufficient. A creditor with information about the estate or the conduct of the debtor's business may be helpful to the trustee.

The Bankruptcy Code permits individual debtors to claim either state or federal exemptions in an effort to give the debtor a fresh start after bankruptcy. Creditors who wish to file an objection to such exemptions must do so within 30 days of the §341 meeting. This requires familiarity with the exemption laws of the state where the debtor resides and some knowledge of the debtor's assets. Creditors must review notices as early as possible in order to meet the deadline.

Comprehension Check

In a Chapter 7, **trustees** must satisfy claims in a particular order. List the priority of claims in order.

Discharge Litigation

A **discharge** *releases individual debtors from personal liability for most debts and prevents the creditors owed those debts from taking any collection actions against the debtor.* Only debtors who meet all of the criteria and adhere to all of the rules of the Bankruptcy Code are granted a discharge through the Bankruptcy Code. Creditors may file an objection to a discharge within 60 to 90 days of the §341 meeting.

Chapter 11 Reorganization

Chapter 11, one of the most important provisions of the Bankruptcy Code, was designed to be a *single, unified way of dealing with a reorganization of most businesses.* One objective of Chapter 11 is to reorganize a troubled debtor while maximizing the return to creditors. Another objective is to retain employment and other economic benefits that the community derives from the business.

Comprehension Check

What is the purpose of **Chapter 11?**

Key Players

The key players in a Chapter 11 case include the judge, who decides the relevant legal issues; the U.S. Trustee, who appoints the creditors' committee and has general oversight responsibility; secured creditors; equity security holders; the debtor; and the creditors' committee. Where appropriate, the court may order the appointment of a trustee to operate the debtor's business or an examiner to investigate its affairs.

Comprehension Check
Who are the key players in a Chapter 11 proceeding?

Types of Petition and Jurisdiction

A case starts with the filing of a voluntary or involuntary bankruptcy petition. The petition may be filed by either a debtor or by its creditors. A petition is required to be filed in the location where the principal place of business or principal assets of a debtor have been located for 180 days or the longer portion of 180 days immediately preceding the filing of the petition than in any other location. Often, a Chapter 11 debtor may advocate for a jurisdiction that is more convenient to it and attempt to choose friendly courts. Improper filings are not permitted and are transferred to the proper venue. Jurisdiction and venue can be important to the case. Creditors can file a motion with the court to move the venue of the case.

Most bankruptcy petitions are initiated by the debtor. The filing of a petition by a debtor automatically creates an automatic stay, which generally prevents creditors from enforcing prepetition claims or from seeking recourse against the debtor's assets without permission from the court.

An **involuntary petition** may be filed by creditors under either Chapter 7 or Chapter 11. As a general rule, *if a debtor has 12 or more creditors, at least three creditors—with unsecured, noncontingent, undisputed claims—are needed to be petitioning creditors.* The three creditors' claims must aggregate $715,775 (subject to increase for inflation) in order to force an involuntary bankruptcy. The involuntary petition is served upon the debtor together with a summons in the same manner in which an adversary proceeding would be commenced. Normally, a debtor has 20 days to contest an involuntary petition.

Role of the Trustee

Under Chapter 11, the U.S. Trustee is required to attempt to appoint a creditors' committee, except in small business cases, in which a committee is not appointed. The Code specifically authorizes the U.S. Trustee to approve and appoint a prepetition committee if it is appropriately representative.

In most instances, the U.S. Trustee may contact the seven largest unsecured creditors from the list filed with the petition for relief by the debtor and solicit their willingness to serve on the committee. Committees generally have odd numbers of members to avoid the issue of tied votes. Unless and until a liquidating or operating trustee is appointed, *a debtor remains in possession of its assets and will manage its own affairs, protected by the automatic stay.* The **debtor in possession,** or **DIP,** *has a fiduciary obligation to the creditors, much the same as a court-appointed trustee.* The U.S. Trustee will normally file a formal pleading with the court stating the names and addresses of the particular creditors appointed to serve on the committee.

Debtor in Possession

The debtor in possession is required to file periodic, standardized financial reports with the U.S. Trustee and the bankruptcy court. The reports are usually provided to the creditors' committee and are available to all creditors. Creditors can review the reports to monitor the financial affairs and performance of the debtor. Failure to file these financial reports could be grounds for the case to be dismissed or converted to a Chapter 7 (liquidation). The debtor in possession has the broad authority to conduct the business under the general supervision of the U.S. Trustee and the creditors' committee, if there is one. The debtor usually has the exclusive right to file a reorganization plan for the first 120 days of the bankruptcy case, subject to extensions up to a maximum of 18 months following the filing of the bankruptcy petition. This deadline cannot be further extended by the court.

Proof of Claim

As in a Chapter 7, creditors in a Chapter 11, should always file a **proof of claim** *which is a written statement that notifies the bankruptcy court, the debtor, the trustee and their parties that a creditor wants to assert its rights to receive a distribution or payment from the bankruptcy estate.* Creditors who have filed a claim but are not listed as a potential distributee must file an objection to determine why their claim is not included for distribution. It may have been a simple oversight by the trustee. A creditor that does not object may lose its claim for good when the court approves the distribution.

A superpriority claim can be authorized by a court during a Chapter 11 proceeding. The **superpriority claim** *has priority over other administrative claims.* The court generally authorizes a superpriority claim to a post-petition lender when a debtor in a Chapter 11 case is unable to obtain new credit during the Chapter 11. If the Chapter 11 is converted into a Chapter 7 liquidation, the superpriority claimant has the first claim on all unencumbered assets. Technically, a bank that lends to a debtor in possession during a Chapter 11 is an administrative creditor equal with all other administrative creditors; yet, if granted superpriority status, the bank is in a relatively safe position.

Notifications

The Bankruptcy Code gives all creditors the right to be notified about many actions that affect the operation of the business and the assets of the bankruptcy estate. The debtor is limited in its ability to use cash collateral, such as cash from the sale of inventory or the collection of receivables that is subject to a prepetition lien. If the cash collateral is subject to valid prepetition security interests, the debtor will attempt to obtain the express permission of the creditor holding the security interest. With the creditor's permission or upon a motion by the debtor, a court order allowing the use of cash collateral will be sought. Before the debtor and the bank can arrange for the use of cash collateral, the debtor must notify all parties in interest of the proposed agreement and its terms.

Any post-petition unsecured credit obtained by the debtor outside the ordinary course of business needs court approval before it can become effective. Some types of unsecured post-petition credit, such as post-petition trade credit, which the debtor requires in its ordinary course of business operations, do not require notice or court approval. Unsecured creditors should examine, and may wish to object to, notices of post-petition credit requests that may affect their claim on remaining unencumbered assets.

The Creditors' Committee

The Bankruptcy Code requires the U.S. Trustee to attempt to form a creditors' committee of creditors willing to serve. The **creditors' committee** *has the responsibility to protect all unsecured creditors' interests, and it oversees the debtor's operations until, and sometimes after, confirmation of the plan.* It will investigate the debtor's affairs, monitor its business and negotiate a Plan of Reorganization for the benefit of unsecured creditors. It has the right to investigate questionable transactions in which the debtor or its principals might have engaged.

Congress intended that the committee be a key player in a Chapter 11 case. The committee consists of unsecured creditors selected by the U.S. Trustee, often the holders of large claims who have the most at stake. The Code provides that a small creditor whose claim is disproportionately large is also entitled to serve on a committee. The goal is for the committee to be truly representative of its constituents. The U.S. Trustee can approve a prepetition committee as the official committee if it fairly represents the creditors. The committee has a fiduciary duty to represent all creditors rather than the specific interest of an individual creditor appointed to the committee.

The financial stake of committee members, along with their expertise in the industry, gives them tremendous influence in a case. The committee may participate in all aspects of a case. Courts often rely on the committee and its positions in deciding how to act on various issues. The committee's recommendation is often the decisive factor on the question of whether a plan will be confirmed.

The law does not stipulate how committees must operate. Most committees meet at the members' convenience and operate according to committee-approved bylaws, which address issues such as meeting frequency and location, quorum and voting protocol. Official creditors' committees are allowed to retain counsel, accountants, and other professionals at the expense of the estate, with these professional fees paid before any distribution is made

to creditors. Creditors serving on the official creditors' committee are allowed to submit their necessary and reasonable expenses for approval by the bankruptcy court for reimbursement. All fees by professionals are subject to review and approval by the court.

The committee cannot tell the debtor or the debtor's officers how to run the business, but if its suggestions are not considered, it may bring the issue before the court for ruling. The committee may have to deal with fraudulent or preferential transfer actions, sometimes against committee members. The committee may also ask the court for the authority to pursue an avoidance action against a secured creditor with an improperly perfected claim. A particular strength of the committee is its ability to recommend or oppose confirmation of a proposed plan of reorganization.

The committee must provide all creditors it represents with access to information concerning an ongoing Chapter 11 proceeding. Further, the committee is directed to seek comment from its constituent creditors. Many committees establish websites for the use of the committee in fulfilling this responsibility. These websites will generally provide the following:

1. General case information including dockets.
2. Monthly committee reports summarizing ongoing events in the case.
3. Highlights of significant events in the case.
4. Access to the claims docket.
5. Press releases (if any).
6. A non-public forum for creditors to submit questions, comments and requests for information.
7. Responses to creditor inquiries, if appropriate. The committee may also send private responses to a specific creditor.
8. Answers to frequently asked questions.
9. Links to other relevant websites.

Comprehension Check

What is the role of a **creditors' committee** in a Chapter 11 proceeding?

Assumption or Rejection of Executory Contracts

Section 365 of the Bankruptcy Code governs the debtor's and creditor's rights under an executory contract. Neither §365, nor any other section of the Bankruptcy Code, defines an executory contract. Congress has left it to the courts to develop a definition. Most courts define an **executory contract** *as an agreement under which both parties remain obligated to perform their obligations under the contract, and any party's failure to perform excuses the other party from continuing to perform its remaining duties under the contract.* Examples of executory contracts include long-term supply agreements where there is an ongoing requirement for the supply and purchase of goods, and where the buyer is required to purchase a certain minimum quantity of goods. Other executory contracts include purchase orders, consignment agreements and service agreements, such as advertising and subscription fulfillment contracts.

Section 365(a) of the Bankruptcy Code permits a Chapter 11 debtor to assume or reject an unexpired executory contract or lease, subject to court approval. This provision enables a debtor to retain valuable contracts and reject burdensome, unprofitable contracts. A debtor that decides to assume an executory contract or lease must satisfy Bankruptcy Code §365(b)'s requirements. They include curing all payment and other defaults under the contract, including fully paying the creditor's prepetition and post-petition claims, and providing adequate assurance of the debtor's ability to fully perform all of its future obligations under the contract.

Comprehension Check

How long does a debtor have to assume or reject **executory contracts,** with court approval, under a Chapter 11 proceeding?

With court approval, the debtor has up to the earlier of confirmation of a Chapter 11 Plan or 120 days after the bankruptcy filing to assume or reject unexpired leases of nonresidential real property. The court may extend this period for up to one additional 90-day period, provided it is granted before the expiration of the initial 120-day period. The criteria used by the debtor are

whether it will be financially more advantageous to reject the leases, assume them and sublease, or sell them. The committee will monitor executory contracts very closely. Creditors will not want an executory contract assumed with the risk of subsequent rejection because that would give the contractor an administrative claim for all or most of the post-petition balance of the contract.

Plan of Reorganization

A minority of all Chapter 11 cases result in a reorganization plan. Most filings are either converted to Chapter 7 or dismissed. The classification and treatment of claims is the heart of any reorganization plan. Under the Bankruptcy Code, a **claim** is a *right to payment or a right to some equitable remedy such as injunctive relief in the event of a breach of contract.* A claim may be contingent or disputed and may not have matured at the time of filing. **Secured creditors** *are creditors holding liens or security interests in assets of the estate.* **Undersecured claims** *are those where the value of the collateral is less than the amount of the claim held by the creditor; they are partially secured and partially unsecured.* All other claims are unsecured. An **unsecured creditor** *is one who extended credit to a debtor without a collateral security.* Secured claims and priority claims (including wage claims and taxes) are entitled to be satisfied from unencumbered assets of the estate ahead of general unsecured claims.

Underlying any plan of reorganization is the method for classifying claims and the proposed treatment for each class. The Bankruptcy Code requires that at least one class must accept the plan before the court will consider it.

In most Chapter 11 cases, the debtor in possession has the exclusive right to file a plan of reorganization for 120 days up to 18 months, if extended following the petition for relief. This is reduced to 180 days, or if extended, to a 300-day deadline for filing a plan for small businesses. Depending on the complexity of the case, some of the requirements regarding the filing of the reorganization plan and disclosure statement are simplified for small business cases to allow them to exit bankruptcy sooner. When a trustee is appointed, the exclusive right is automatically terminated. When the debtor's exclusive period has ended, any interested party, including the debtor, can file a reorganization plan. If the debtor is a corporation, the corporate officers or the board of directors may propose a plan. Shareholders also can propose a plan, but not on behalf of the debtor. Partners may propose a plan for a partnership. The creditors' committee or even a single creditor can propose a plan. Outsiders may attempt to acquire the debtor's assets or even the debtor as a form of corporate takeover.

The Code also provides a fast track for small businesses. A **small business** *is defined as a person engaged in commercial or business activities, excluding real estate, whose aggregate noncontingent liquidated and unsecured debts as of the date of the petition do not exceed $2,566,050* (subject to increase for inflation). In addition, a debtor who owns only a single real estate asset is also provided with a means to a fast resolution. A **single asset real estate debtor** *is defined as real property constituting a single property or project with less than four residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto.* Plans and other deadlines in these cases are far shorter than in the normal Chapter 11 case.

Comprehension Check

Define the term **claim,** under the Bankruptcy Code.

How is a **small business** defined under Chapter 11 of the Bankruptcy Code?

Secured Creditors

Usually the courts require each secured creditor to be placed in a separate class. If two or more secured creditors have equal claims against the same collateral, they all may be placed in one class. The potential treatments of secured creditors often depend on the value of their collateral. If the value is the same as or more than the amount of the claim, the proponent of the plan may surrender the collateral in full satisfaction of the claim. In other cases, the debtor may propose retaining the collateral and reamortizing the debt, selling the collateral and giving the secured creditor an equivalent lien on other assets, or selling the collateral and using the proceeds to pay administrative expenses and the secured creditor. The creditors' committee or an individual creditor should review the

validity of secured creditors' security interests to see if they have cause to object if one or more of them adversely affect the payment to unsecured creditors.

Unsecured Creditors

The Bankruptcy Code requires that all claims of a similar nature in a single class be treated the same. Courts will generally approve a plan that puts all unsecured creditors in a single class, but this may cause problems when the unsecured creditors have to vote on a plan if there is great disparity among the claims. Plans must be approved by a minimum of one-half the number and two-thirds the amount of the claims that vote in any one class. In such cases, one large claim or many small claims could prevent acceptance of the plan. Courts may also approve a plan where unsecured creditors are divided into several classes based on their relationship to the creditor or another factual basis relating to the case. This allows for more homogeneous classes. Creditors should examine plans to see how the classification process affects their interests. Specific things to watch for are:

- Multiple classes of unsecured creditors where one or more classes receive more favorable treatment than other classes.
- A single class of unsecured creditors that logically should be split into more than one class.
- An administrative convenience class where the minimum size of the claim is set at a relatively high figure to include all trade creditors (and win acceptance by this class) and exclude creditors with unsecured deficiency claims.

Creditors may file objections to the classifications of claims in a plan before the confirmation hearing, or earlier. Plans vary from **extension plans** *which provide unsecured creditors full payment over time* to **compromise plans** *(partial payment)* to no payment at all. The creditors' main concern in the reorganization plan is the kind of payment the plan proposes for the creditors' class. The only reason an unsecured creditor might consider a plan that provides no payment at all for its class is if there are no assets to be salvaged by liquidation, operation, or by sale. **Partial payments** *are usually for a percentage of unsecured claims either when the plan is confirmed or over time.* The timing of payments will affect the willingness of creditors to approve the plan. Unsecured creditors evaluating a proposed reorganization plan should compare the payment being offered against the liquidation value of the debtor's assets. **Pot plans** *set aside some of the debtor's assets for liquidation and distribution to the unsecured creditors.* This is usually done to gain the approval of the unsecured creditors although the value of the assets in the pot to be divided is usually difficult to estimate. Extension plans are uncommon, but sometimes the debtor will offer a **debt for equity swap** *which is a transaction in which the obligations* ***(debts)*** *of a company or individual are exchanged for something of value* ***(equity).*** In the case of a publicly-traded company, this would generally entail an exchange of bonds for stock. A plan can include a variety of payment plans and can offer payment choices to the classes of creditors. The danger in liquidation for unsecured creditors is that secured, administrative and other priority claims may absorb all of the liquidation proceeds, leaving nothing for general unsecured claims.

Comprehension Check
How are claims classified under the Bankruptcy Code?

Interest Classification and Treatment

Whether the business is a sole proprietorship, partnership or corporation, the plan must classify the ownership interest and propose treatment. Equity holders are normally the last to receive any payment, and a plan must be accepted by creditors or pay them in full before equity holders may receive any payment.

Provision for Execution of Plan

A reorganization plan should spell out how the assets, claims and interests will be treated, as well as give specifics and a time schedule for any sale, liquidation or restructuring of the business, including deadlines for the distribution of any payments. A plan may also contain additional optional provisions. A plan may not discharge the guarantee claim of a creditor against a principal of the business if the guarantee holder objects.

The Bankruptcy Code requires that a proponent of a plan disclose certain information in conjunction with the solicitation of the votes on the plan and that the court must approve the disclosure statement. In general, protracted litigation over the amount of the information disclosed by the proponent of the plan is counterproductive. Such litigation wastes estate assets and can delay a plan whose success depends on speedy action and distribution to the creditors. The disclosure statement is sent pro forma to the creditors' committee and the major secured creditors only, and a hearing date is set. Other creditors must request a copy in writing from the debtor's lawyer. Objections must be received before a deadline set by the court and can be argued at the hearing. Under §1111(b), certain undersecured creditors may elect to have their claim treated as though it were fully secured for confirmation purposes. Creditors with this option should consult counsel. No one may solicit rejections or acceptances of a plan until the court has approved the disclosure statement.

Comprehension Check
What information is contained in a **plan of reorganization?**

Voting Process

For a plan to be accepted, a majority in each class must vote to accept it. A **majority** *is defined as those holding at least two-thirds in amount and one-half in number of the allowed claims voting on the plan.* The bankruptcy court may disallow votes procured in bad faith, such as in return for a payment, or not in accordance with the Bankruptcy Code. The law requires that a formal ballot either accepting or rejecting the proposed plan be returned to the court or to counsel in order to be counted.

Ballots are sent to the creditors with the proposed plan. Ballots must be returned before the deadline in order to be counted. After the deadline, counsel for the plan's proponent files a certificate of voting that lists all ballots, including those that are disputed or were returned late, and gives the result of the voting. The plan proponent or the debtor will sometimes object to a particular claim and request the court to disallow it for voting purposes. This is usually done to affect the results of the vote on the plan. Creditors that receive such an objection to their claim must respond by a given deadline and request a hearing or risk having the claim disallowed. Sometimes competing plans are sent to creditors simultaneously. It is permissible to have only one ballot that allows creditors to express their preference for one plan over the other.

The Confirmation Process

Confirmation *refers to court approval of the plan.* The first step is to file the reorganization plan and the disclosure statement. After the disclosure statement is approved as presenting the necessary information, all creditors entitled to vote receive a notice of the confirmation hearing, a copy of the reorganization plan and the disclosure statement. The court may choose to combine the hearings on the plan and the disclosure statement to save time and expense. A combined hearing also occurs in small business Chapter 11 cases. The notice also includes the identity of the proponent of the reorganization plan, a ballot for voting on the plan, deadlines for filing objections and for returning ballots, and provides directions on where to send completed ballots. Objections should be explained as specifically as possible and filed promptly—usually a week or so before the date set for the confirmation hearing. The ballots are tallied and reported to the court. Plan proponents are allowed to submit modifications to the reorganization plan up until the confirmation hearing. If the modification does not affect all classes or improves the treatment for one class, it does not have to be resubmitted to the creditors for another general vote. There is no set procedure for a confirmation hearing. The procedure is determined, to a large extent, by the objections filed and the complexity of the case. The court is likely to confirm the plan if all classes of creditors and interest holders have accepted it by the necessary majorities, and the unsecured creditors will get a distribution that equals or exceeds what they would receive in liquidation. *The bankruptcy court is allowed to confirm a plan that has been rejected by one or more classes. This is known as a* **cramdown,** *and is more often a threat than a reality.* Cramdown procedures differ depending on the creditor class involved.

Comprehension Check
In order for a **plan of reorganization** to be accepted, what is necessary?

The Absolute Priority Rule

An **absolute priority rule** *stipulates the order of payment in the event of liquidation. Debts to creditors will be paid first and shareholders (partial owners) divide what remains.* The absolute priority rule prevents confirmation of a reorganization plan without the consent of the necessary classes of creditors if the plan provides that the shareholders in the corporation or the individual debtor in an individual case will retain an interest in assets after confirmation. The rule comes into play if the debtor proposes to pay less than 100 percent of all allowed claims and the holders of those claims do not accept the plan by the necessary majority. The absolute priority rule bars confirmation of the reorganization plan unless the creditors accept it by the necessary majority, or it provides for full payment to the creditors or wipes out all junior classes.

Comprehension Check
What is the **absolute priority rule?**

Postconfirmation Problems

The Bankruptcy Code permits the proponent of the plan to make postconfirmation modifications only if a substantial transfer of assets as outlined in the plan has not already taken place. Only the plan proponents can request such a modification. Postconfirmation modifications tend to be for the purpose of correcting technical errors and are not significant changes in the plan. If the modification changes the rights of the creditors in the original confirmed plan, then the creditors must vote on the modifications. The court may consider dismissing a case after a plan has been confirmed if the plan has not been substantially consummated. This is rare because of the difficulties in reversing the effects of the confirmation. Postconfirmation conversion of a case to Chapter 7 is possible if the debtor fails to substantially consummate the confirmed plan or materially defaults on the plan. If this happens, the creditors are notified in advance about the court motion required for the conversion. If the confirmation was obtained by fraud, the court may revoke it, but only within the first 180 days after the confirmation order was entered. The authority for enforcing the plan is split between the bankruptcy court and the state court. The bankruptcy court usually has jurisdiction until the plan is substantially consummated. Generally, creditors may use the state courts to sue a debtor who has defaulted on an extension payment under a confirmed plan.

Prepackaged Chapter 11

A **prepackaged bankruptcy,** referred to as a **prepack,** is a Chapter 11 case *where the debtor reaches an agreement with its creditors and other relevant constituencies prior to the filing of the Chapter 11 case.* The agreement is documented in a plan of reorganization and voted on by the relevant constituencies before a bankruptcy petition is filed. Trade creditors are usually paid in full in a prepackaged plan.

There are various reasons prepackaged bankruptcies are favored. First, they allow a debtor to shorten and simplify the bankruptcy process. The process to obtain approval of a prepackaged Chapter 11 plan could be as short as 30-60 days after the Chapter 11 filing date. Second, the debtor is able to minimize its legal and other professional fees and other costs generally associated with operating in Chapter 11. Third, a prepackaged bankruptcy limits the uncertainty associated with the Chapter 11 process because the votes needed to confirm a plan are already solicited prior to the filing. Finally, this avenue allows a debtor to maximize going concern value and, in turn, minimize the bankruptcy's impact on trade creditors, customers, employees and day-to-day operations.

Prearranged Chapter 11

A **prearranged Chapter 11 case,** unlike a prepackaged case, *occurs when the debtor reaches an agreement with one or more, but not all, of the debtor's creditor constituencies (most often the debtor's secured lender owed significant sums) on the terms of a Chapter 11 plan prior to the filing of the Chapter 11 case.* In a prearranged case, the debtor negotiates with the lender for debtor-in-possession financing, prepares first-day pleadings, and prepares a disclosure statement and plan of reorganization for an immediate post-filing solicitation of creditors. The goal is to file for Chapter 11 and oftentimes obtain expedited approval of the disclosure statement and plan of reorganization,

and then to exit bankruptcy within several months of the bankruptcy filing date. Trade creditors are not assured full or any payment in a prearranged Chapter 11 case.

Chapter 12 Adjustments of Debts of a Family Farmer or Fisherman with Regular Annual Income

Congress adopted **Chapter 12** of the Bankruptcy Code in 1986 *providing special provisions relating to the reorganization of family farmers and family fishermen.* It has some of the provisions found in Chapters 11 and 13 of the Bankruptcy Code.

Family farmers include individuals and spouses, corporations and partnerships whose aggregate debts do not exceed $4,153,150, of which 50 percent must be from farming operations. Total liabilities for a family fisherman cannot exceed $1,924,550, of which 80 percent must be from a commercial fishing operation. The thresholds are periodically adjusted for inflation. The *debtor initiates Chapter 12 by filing a document called* a **petition for relief** with the bankruptcy court. A **standing trustee** is appointed in each Chapter 12 case *to serve as the disbursing agent for payments under the plan of repayment.* However, due to the relative infrequency of filing of petitions for Chapter 12 (family farmer debt adjustment) relief, trustees for these cases are typically appointed on an *ad hoc* basis.

A Chapter 12 plan of repayment must be filed only by the debtor within 90 days after the filing of the petition for relief. As in Chapter 11, plans must classify creditors and propose treatment for each class.

Confirmation

Chapter 12 eliminates the absolute priority rule, which means the farmer may retain the family farm and make minimal payments to unsecured creditors. Creditors do not vote on the plan, and the debtor is not required to make a disclosure statement. Plans must satisfy two conditions:

1. Creditors are to receive what they would receive under liquidation (the liquidation test).
2. All the debtor's disposable income for three to five years must be paid to creditors (the best efforts test).

Chapter 12 allows a debtor keep the farm, revalue secured creditors over time on the current market value of the land, treat the balance of the debt as an unsecured claim and discharge all unsecured claims with nominal payments.

Trade Creditors' Primary Concerns

Creditors' concerns in a Chapter 12 case are to protect their secured position. Unsecured creditors may assert their right to the debtor's disposable income and any liquidation dividend. The trustee usually checks the debtor's income and expenses and claims the difference for distribution to creditors.

Comprehension Check
What two conditions must a plan satisfy under **Chapter 12?**

Chapter 13 Adjustments of Debts of an Individual with Regular Income

Chapter 13 *affords an individual with regular income an opportunity to reorganize their debts.* Prior to the 1978 code, only wage earners were eligible. Now the source of income is not relevant, but it must be regular as opposed to sporadic income received.

There are three criteria for filing under Chapter 13:

1. The debtor must be an individual.
2. The individual must have regular income.
3. The debt's limit is $394,725 in unsecured debt and $1,184,200 in secured debt. The thresholds are periodically adjusted for inflation.

Summary of a Typical Case

The debtor files a petition and a plan for handling the debts with the bankruptcy court in the district where the debtor resides. A plan must be filed within 15 days of filing the petition.

The case is then referred to the standing trustee who handles all Chapter 13 cases in a designated locality. The standing trustee will move to dismiss the case if the debtor fails to file a plan. The **standing trustee** *handles the administration of the case and presides at the §341 meeting, making recommendations to the court regarding confirmation of the plan.* The standing trustee is also responsible for collecting money from the debtor and distributing it to the creditors, as outlined in the confirmed plan. The standing trustee should be able to answer questions pertaining to the status of the case or about distributed payments.

The plan must classify creditors and propose treatment for their claims. Total payments to unsecured creditors must meet the liquidation test under Chapter 7. Like most Chapter 7 cases, which make no payments to unsecured creditors, Chapter 13 cases often make no payments to unsecured creditors as well. The plan may provide for payments to make up a monetary default for a homestead mortgage or other secured debt to prevent these assets being foreclosed and sold by the creditors.

Creditors must file claims in order to receive any distributions under the plan. Plans tend to be either extension plans or composition plans. **Extension plans** *pay all creditors in full over the duration of the plan.* There are two types of composition plans. *Both types of* **composition plans** *make only partial repayments of the total debt to creditors, and both must continue for not more than five years.* In one type, the debtor pays a fixed dollar amount monthly that is the surplus of net income after deducting expenses and payments to secured creditors. This amount is distributed *pro rata* among the unsecured creditors. In the second kind of composition plan, the plan pays a fixed percentage of the allowed claims to each unsecured creditor in monthly payments that continue until the percentage of each allowed claim has been paid. The court may stipulate that payments be for more than five years, even if it means that creditors receive more than the plan calls for.

The confirmation hearing may be brief unless the trustee or a creditor objects. The standing trustee's main concern is meeting the confirmation tests. One test is the **liquidation test:** *Will the total amount of plan payments equal the amount distributed to unsecured creditors through a Chapter 7 liquidation?* The second test is the **best efforts test:** *Will the debtor be paying creditors all of their disposable income for at least five years?* The court usually will not confirm the plan unless objections of the standing trustee are amended. Under Chapter 13, the discharge comes only after the debtor has made all payments required under the plan. The discharge is only for the claims dealt with under the plan.

Comprehension Check
List the three criteria for filings under **Chapter 13.**

The Chapter 20 and Chapter 22 Maneuver

This refers to serial bankruptcy filings where, because of the size of the debt, a debtor files a Chapter 7 petition to discharge the unsecured claims and, as soon as the discharge is granted, files a Chapter 13 petition to deal with the secured claims. The name Chapter 20 refers to the combination of 7 plus 13. This is expected to occur less frequently as Congress raised the debt limits and imposed a means test for Chapter 7 debtors. Chapter 22 refers to a company that has filed Chapter 11 twice.

Establishing a Systematic Response to Bankruptcy Filings

Creditors must establish an efficient internal system of routing bankruptcy notices so that information gets to the proper individuals. The Bankruptcy Code requires a debtor to send notices to an address specified by the creditor in communications sent to the debtor within 90 days of the bankruptcy filing.

The credit professional, or whoever is in charge of bankruptcy cases, needs to be aware of deadlines for meetings of creditors, filing of proofs of claim, objections to the sale of assets, etc. The sales department should be provided with instructions concerning the effect of the bankruptcy filing on existing credit limits and any need for consultation on post-petition sales. Many of the deadlines are relatively short, so a creditor may need to send a notice with a change of address to the bankruptcy court if the debtor or the trustee is mailing notices to a lockbox or another office where rerouting may involve unnecessary delay. It is imperative to establish procedures for staff that deal with receipts at the lockbox address for handling bankruptcy notices.

A separate system should be established to deal with adversary proceedings in which the company is sued by the debtor or some other party in the bankruptcy case. A company's bankruptcy system should include a periodic review with the sales and other staff members who have direct contact with a customer. The staff should be educated about the importance of being alert to bankruptcy danger signs and what actions to take upon learning of a bankruptcy filing.

Comprehension Check

Why is it important to establish a systematic response system for bankruptcy cases?

Filing a Proof of Claim

In cases under Chapters 7, 12 and 13, the filing of a proof of claim is generally required to participate in any distribution of the bankruptcy estate assets to unsecured creditors. In a Chapter 11 case, a claim is deemed to be filed for any claim or interest that the debtor correctly lists in the schedules without indicating that the claim is disputed, contingent, or unliquidated. The creditor should review its claim as listed by the debtor in the schedules. The creditor must file a proof of claim if the claim listed is incorrect or listed as disputed, contingent or unliquidated. Technically any document filed with the bankruptcy court in order to set forth your rights to payment of a debt may be considered a proof of claim.

In a Chapter 7, all proofs of claim must be filed within 90 days after the first date set for the §341 meeting of creditors unless the creditor receives notice of a no asset case and of the non-necessity to file a claim. When dealing with a Chapter 11, the Federal Rule of Bankruptcy Procedure Rule 3003(c) allows the bankruptcy court to establish a deadline. Chapter 12 follows Rule 3002(c) that provides that all claims must be filed within 90 days of the first date set for the §341 meeting. In a Chapter 13, all proofs of claim must be filed within 90 days after the first date set for the §341 meeting. If the §341 meeting is rescheduled, the filing date does not change. If the 90th day falls on a holiday or a weekend day, the next workday is the deadline.

The Official Proof of Claim Form

The official **Proof of Claim Form 410** should be used to file proofs of claim in all cases and can be downloaded from the United States Court website at uscourts.gov. Claims should be prepared in duplicate and may be signed by any person within the creditor company authorized to do so. This includes an officer or an attorney for the company. Most bankruptcy courts have electronic filing systems for court documents and proofs of claims. The creditor should check with the court as to whether electronic filing of the claim is required.

Comprehension Check

Under what chapters of the Bankruptcy Code must a proof of claim be filed?

Figure 17-1 Proof of Claim Form

Fill in this information to identify the case:

Debtor 1 _____

Debtor 2 (Spouse, if filing) _____

United States Bankruptcy Court for the: _____ District of _____

Case number _____

Official Form 410

Proof of Claim

04/16

Read the instructions before filling out this form. This form is for making a claim for payment in a bankruptcy case. Do not use this form to make a request for payment of an administrative expense. Make such a request according to 11 U.S.C. § 503.

Filers must leave out or redact information that is entitled to privacy on this form or on any attached documents. Attach redacted copies of any documents that support the claim, such as promissory notes, purchase orders, invoices, itemized statements of running accounts, contracts, judgments, mortgages, and security agreements. **Do not send original documents;** they may be destroyed after scanning. If the documents are not available, explain in an attachment.

A person who files a fraudulent claim could be fined up to $500,000, imprisoned for up to 5 years, or both. 18 U.S.C. §§ 152, 157, and 3571.

Fill in all the information about the claim as of the date the case was filed. That date is on the notice of bankruptcy (Form 309) **that you received.**

Part 1: Identify the Claim

1. **Who is the current creditor?**

   _____
   Name of the current creditor (the person or entity to be paid for this claim)

   Other names the creditor used with the debtor _____

2. **Has this claim been acquired from someone else?**

   ❑ No
   ❑ Yes. From whom? _____

3. **Where should notices and payments to the creditor be sent?**

   Federal Rule of Bankruptcy Procedure (FRBP) 2002(g)

Where should notices to the creditor be sent?	**Where should payments to the creditor be sent?** (if different)
_____ Name	_____ Name
_____ Number Street	_____ Number Street
_____ City State ZIP Code	_____ City State ZIP Code
Contact phone _____	Contact phone _____
Contact email _____	Contact email _____

Uniform claim identifier for electronic payments in chapter 13 (if you use one):

_ _

4. **Does this claim amend one already filed?**

   ❑ No
   ❑ Yes. Claim number on court claims registry (if known) _____ Filed on _____ MM / DD / YYYY

5. **Do you know if anyone else has filed a proof of claim for this claim?**

   ❑ No
   ❑ Yes. Who made the earlier filing? _____

Figure 17-1 Proof of Claim Form continued

Part 2: Give Information About the Claim as of the Date the Case Was Filed

6. **Do you have any number you use to identify the debtor?**
   - ❑ No
   - ❑ Yes. Last 4 digits of the debtor's account or any number you use to identify the debtor: ____ ____ ____ ____

7. **How much is the claim?** $_____. **Does this amount include interest or other charges?**
   - ❑ No
   - ❑ Yes. Attach statement itemizing interest, fees, expenses, or other charges required by Bankruptcy Rule 3001(c)(2)(A).

8. **What is the basis of the claim?**

   Examples: Goods sold, money loaned, lease, services performed, personal injury or wrongful death, or credit card.

   Attach redacted copies of any documents supporting the claim required by Bankruptcy Rule 3001(c).

   Limit disclosing information that is entitled to privacy, such as health care information.

   _____

9. **Is all or part of the claim secured?**
   - ❑ No
   - ❑ Yes. The claim is secured by a lien on property.

   Nature of property:
   - ❑ Real estate. If the claim is secured by the debtor's principal residence, file a *Mortgage Proof of Claim Attachment* (Official Form 410-A) with this *Proof of Claim.*
   - ❑ Motor vehicle
   - ❑ Other. Describe: _____

   Basis for perfection: _____

   Attach redacted copies of documents, if any, that show evidence of perfection of a security interest (for example, a mortgage, lien, certificate of title, financing statement, or other document that shows the lien has been filed or recorded.)

   Value of property: $_____

   Amount of the claim that is secured: $_____

   Amount of the claim that is unsecured: $_____ (The sum of the secured and unsecured amounts should match the amount in line 7.)

   Amount necessary to cure any default as of the date of the petition: $_____

   Annual Interest Rate (when case was filed)_____%
   - ❑ Fixed
   - ❑ Variable

10. **Is this claim based on a lease?**
    - ❑ No
    - ❑ Yes. **Amount necessary to cure any default as of the date of the petition.** $_____

11. **Is this claim subject to a right of setoff?**
    - ❑ No
    - ❑ Yes. Identify the property: _____

Official Form 410 **Proof of Claim** page 2

Figure 17-1 Proof of Claim Form continued

12. **Is all or part of the claim entitled to priority under 11 U.S.C. § 507(a)?**

A claim may be partly priority and partly nonpriority. For example, in some categories, the law limits the amount entitled to priority.

- ❑ No
- ❑ Yes. *Check one:*

	Amount entitled to priority
❑ Domestic support obligations (including alimony and child support) under 11 U.S.C. § 507(a)(1)(A) or (a)(1)(B).	$_____
❑ Up to $2,850* of deposits toward purchase, lease, or rental of property or services for personal, family, or household use. 11 U.S.C. § 507(a)(7).	$_____
❑ Wages, salaries, or commissions (up to $12,850*) earned within 180 days before the bankruptcy petition is filed or the debtor's business ends, whichever is earlier. 11 U.S.C. § 507(a)(4).	$_____
❑ Taxes or penalties owed to governmental units. 11 U.S.C. § 507(a)(8).	$_____
❑ Contributions to an employee benefit plan. 11 U.S.C. § 507(a)(5).	$_____
❑ Other. Specify subsection of 11 U.S.C. § 507(a)(__) that applies.	$_____

* Amounts are subject to adjustment on 4/01/19 and every 3 years after that for cases begun on or after the date of adjustment.

Part 3: Sign Below

The person completing this proof of claim must sign and date it. FRBP 9011(b).

If you file this claim electronically, FRBP 5005(a)(2) authorizes courts to establish local rules specifying what a signature is.

A person who files a fraudulent claim could be fined up to $500,000, imprisoned for up to 5 years, or both. 18 U.S.C. §§ 152, 157, and 3571.

Check the appropriate box:

- ❑ I am the creditor.
- ❑ I am the creditor's attorney or authorized agent.
- ❑ I am the trustee, or the debtor, or their authorized agent. Bankruptcy Rule 3004.
- ❑ I am a guarantor, surety, endorser, or other codebtor. Bankruptcy Rule 3005.

I understand that an authorized signature on this *Proof of Claim* serves as an acknowledgment that when calculating the amount of the claim, the creditor gave the debtor credit for any payments received toward the debt.

I have examined the information in this *Proof of Claim* and have a reasonable belief that the information is true and correct.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on date _____
MM / DD / YYYY

_____
Signature

Print the name of the person who is completing and signing this claim:

Name _____
First name Middle name Last name

Title _____

Company _____
Identify the corporate servicer as the company if the authorized agent is a servicer.

Address _____
Number Street

_____
City State ZIP Code

Contact phone _____ Email _____

Official Form 410 **Proof of Claim** page 3

Objections to Proofs of Claims

The trustee in Chapter 7, 11 and 13 cases and the debtor in possession under Chapter 11 are statutorily responsible for reviewing claims filed, or listed in a Chapter 11 schedule, to determine whether the claims are proper claims against the estate. Objections to claims can range from inadequate documentation to lender liability lawsuits to the inclusion of precomputed interest. Routine objections often result from communication problems and can usually be resolved without much difficulty. The trustee will charge the estate for all legal expenses relating to claim objections. As this reduces the amount available for distribution to the unsecured creditors, creditors have an incentive to present claims that are as objection-free as possible. Procedures for objecting to claims and resolving those objections vary from court to court. Legal counsel should be sought when dealing with objections. It is imperative that a creditor responds timely to an objection to claim. Failure to respond timely may result in the loss of a claim. While the court may reconsider a claim if a creditor fails to respond, the burden will be on the creditor to prove its reason for not responding. The criteria are **excusable neglect** (refers to a legitimate excuse for the failure to take some proper step at the proper time which is an extremely high burden.

Reclamation

The concept of **reclamation** *is to protect a creditor who delivers goods to a debtor while the debtor is insolvent.* The law provides for return of the goods: The eligible pool of goods subject to reclamation is all goods the debtor had received up to 45 days prior to the filing of bankruptcy, if certain conditions are met. The creditor must send a written reclamation demand for return of the goods. The creditor may send the reclamation demand to the debtor prior to bankruptcy and also has up to 20 days from the filing date to send the demand, but the demand can only cover goods received by the debtor no more than 45 days prior to the receipt of the reclamation demand. This written notice, with a proof of delivery, should include a clear description of the goods, the date of delivery and their value. Because the goods must be in the possession of the debtor in their original unused condition at the time the notice of reclamation is received, it is in the creditor's best interest to send the demand as soon as possible. Sending the debtor the demand via email and then sending the originals via overnight delivery provides a good tracking of when the notice was delivered. The creditor should also maintain proof of the debtor's receipt of the demand. There are no other rights provided to a successful reclaiming creditor other than return of the goods.

One of the flaws in reclamation is that the rights of a reclaiming creditor still remain subject to the rights of a prior secured creditor with a lien in the same collateral sought to be reclaimed.

Reclamation Catch-22: Darned If You Do, Darned If You Don't*

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") amended Bankruptcy Code Section 546(c)(1) and expanded the reclamation reachback period to 45 days in bankruptcy cases filed under BAPCPA. Although BAPCPA's change to Section 546(c) suggests that trade creditors would have substantially expanded reclamation rights, it most certainly has not played out that way in practice.

Reclamation rights have already been besieged in cases, such as Advanced Marketing Services in the Bankruptcy Court for the District of Delaware, where the court denied a reclaiming creditor's motion for injunctive relief to bar the debtor from selling that creditor's goods, and Dana Corporation in the Bankruptcy Court for the Southern District of New York, where the court ruled that reclamation rights were rendered valueless by virtue of the debtor's pre-petition and Chapter 11 secured lenders' alleged floating security interest in all of the debtor's inventory. More recently, in the Circuit City Stores Chapter 11 case, reclamation creditors were dealt a blow for failing to seek emergency injunctive relief at the beginning of the case, exactly the relief that the bankruptcy court in Advanced Marketing Services had rejected because reclamation rights were viewed to be valueless by virtue of the debtor's pre-petition secured lender's floating inventory security interest. The United States District Court for the Eastern

District of Virginia held that a creditor's failure to diligently pursue its reclamation rights resulted in a forfeiture of those rights.

This leaves reclamation creditors in the lurch with the impossible choice of deciding whether to seek emergency injunctive relief at the beginning of the case, a battle they will likely lose at great expense, or forfeit the ability to assert their reclamation rights at a later date (perhaps when secured creditors with floating liens on the reclamation creditors' goods have been paid in full).

State Law Reclamation Rights

Reclamation rights arise under state law and are governed by Section 2-702 of the Uniform Commercial Code (UCC), the uniform state law enacted in all 50 states. Under state law, a trade creditor could reclaim goods delivered to a buyer if the creditor satisfies all of the following conditions: The goods were sold to the debtor on credit terms; the debtor was insolvent at the time it received the goods; and the creditor demanded return of the goods within ten days of the debtor's receipt of the goods.

The UCC defines insolvency based on either a balance sheet test, of liabilities exceeding assets, or an "equity" test, where the debtor has ceased paying its debts in the ordinary course of business or is unable to pay its debts as they become due. A trade creditor that can prove all of the elements of a state law reclamation claim is entitled to recovery of all goods in the debtor's possession that are the subject of its claim.

However, a creditor's state law reclamation rights are subject to the rights of a "good faith purchaser." The UCC defines a "good faith purchaser" to include a secured creditor with a security interest in the debtor's inventory. That means a secured creditor with a floating inventory lien has priority over the rights of a reclaiming creditor.

Reclamation Rights under Bankruptcy Code Section 546(c)

Bankruptcy Code Section 546(c)(1) addresses reclamation rights as follows:

> (1) …[S]ubject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under Sections 544(a), 545, 547 and 549 are subject to the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days of the commencement of a case under this title, but such a seller may not reclaim such goods unless such seller demands in writing reclamation of such goods—(A) not later than 45 days after the date of receipt of such goods by the debtor; or (B) not later than 20 days after the date of the commencement of the case, if the 45-day period expires after the commencement of the case.

Section 546(c)(1), as enacted by BAPCPA, has brought about three significant changes to trade creditors' reclamation rights in bankruptcy cases, compared to their reclamation rights under the pre-BAPCPA version of Section 546(c). First, the reclamation reachback time period has been extended to 45 days. A creditor can reclaim goods that it had sold in the ordinary course of its business on credit to the debtor that the debtor had received within 45 days of bankruptcy. A creditor's reclamation rights are contingent upon the creditor sending a written reclamation demand, identifying the goods, to the debtor not later than 45 days after the debtor's receipt of the goods. If the 45-day period expires after the bankruptcy filing, the creditor has up to 20 days after the bankruptcy filing to send a reclamation demand. This sounds like a substantial expansion of reclamation rights, compared to the shorter time periods provided to reclaiming creditors under state law and the reclamation rights provided in the pre-BAPCPA version of Section 546(c). But don't pop open the champagne bottles quite yet!

Section 546(c)(1) now states that the rights of a reclaiming creditor are subject to the prior rights of a creditor with a security interest in the debtor's inventory, including the goods subject to reclamation. This raises the specter of the pre-BAPCPA case law holdings that a pre-existing pre-petition floating inventory secured claim renders reclamation rights valueless, even when the value of the secured creditor's collateral substantially exceeds the amount of the secured creditors' claim.

Section 546(c)(1) has also eliminated the alternative remedies of an allowed administrative priority claim or replacement lien in lieu of return of the goods that existed in the pre-BAPCPA version of Section 546(c). Current Section 546(c)(1) provides that reclamation of the goods is the sole remedy for a creditor that has satisfied the

requirements for reclamation. BAPCPA's deletion of the alternative remedies for reclamation has raised many questions. Is reclamation a "wasting" right that diminishes as the debtor continues to sell the goods subject to reclamation, because relief is limited to only the goods on hand when the court grants relief? Must reclaiming creditors immediately commence suit in the bankruptcy court to seek injunctive relief at the beginning of the bankruptcy case to block the debtor's sale of, or grant of a security interest in, the goods subject to reclamation? If so, at what cost will reclamation creditors pursue such rights where the probability of success, at least at the beginning of the case, appears bleak? If reclamation creditors choose not to seek injunctive relief at the beginning of the case, will they have forfeited their reclamation rights?

All these issues were addressed in the Circuit City Stores Chapter 11 case.

Circuit City Stores

Background

On November 10, 2008 (the petition date), Circuit City Stores, Inc. and its affiliates filed Chapter 11 in the United States Bankruptcy Court for the Eastern District of Virginia. Prior to its liquidation, Circuit City was a national retailer of consumer electronics. Paramount Home Entertainment Inc. sold and delivered millions of dollars of home entertainment products to Circuit City each year.

Debtors' Financing Arrangement

On the petition date, Circuit City requested approval from the Bankruptcy Court to obtain debtor-in-possession (DIP) financing secured by a first priority lien in substantially all of Circuit City's existing and after-acquired assets, including "inventory" and the proceeds thereof. This inventory included the goods that Paramount had sold to Circuit City. Paramount did not object to the proposed DIP financing. Upon approval of the DIP loan, Circuit City used the DIP loan proceeds to repay all of its outstanding indebtedness under its pre-bankruptcy credit facility, and to finance its ongoing post-petition operations.

Reclamation Procedures

Shortly after the petition date, the Circuit City court approved an order for proposed reclamation procedures, which, among other things, required reclamation claimants to file reclamation demands consistent with Bankruptcy Code Section 546(c) no later than 20 days after the petition date, and required Circuit City to send notice by March 10, 2009 containing what Circuit City considered the allowed amount of reclamation creditors' claims. To the extent Circuit City did not believe a reclamation claimant had an allowed claim, Circuit City was not required to send notice and the claimant's reclamation demand was deemed rejected by Circuit City after March 10, 2009. The reclamation procedures order expressly provided that:

> Nothing in this Order or the above procedures is intended to prohibit, hinder, or delay any Reclamation Claimant from asserting or prosecuting any of its rights to seek to reclaim goods provided to the Debtors, or affect, alter, diminish, extinguish, or expand the rights or interest, if any, to recover goods (or proceeds thereof) sought to be reclaimed.

Paramount's Reclamation Demand

Shortly before the entry of the reclamation procedures order, Paramount sent a reclamation demand—requesting the return of goods totaling approximately $11.6 million—that was compliant with the reclamation procedures order. Circuit City, however, did not send a notice to Paramount by March 10, 2009, pursuant to the order, indicating that Paramount had an allowed reclamation claim, and accordingly, Paramount's demand was deemed rejected by Circuit City. Unrelated to Paramount's reclamation demand, Paramount also filed a proof of claim seeking priority status on account of its reclamation claim.

Circuit City Liquidates

Barely two months into its bankruptcy case, Circuit City decided to liquidate its assets by way of going out of business sales, which, of course, included the sale of Paramount's goods in Circuit City's possession. At no time after sending its reclamation demand did Paramount object to the sale of its goods, nor did Paramount take any steps to

exercise its reclamation rights, such as by commencing an adversary proceeding to stop Circuit City from selling the goods subject to Paramount's reclamation demand.

Circuit City Objects to Paramount's Claim

In June 2009, Circuit City objected to Paramount's priority proof of claim based on Paramount's reclamation claim. Circuit City sought to have the claim reclassified from a priority claim to a non-priority pre-petition general unsecured claim. Paramount objected to Circuit City's proposed reclassification of the priority status of Paramount's reclamation claim. Thereafter, Circuit City filed a summary judgment motion, asserting that there were no disputed issues of fact and that as a matter of law, Paramount's claim should be reclassified from a priority claim to a general unsecured claim.

The Bankruptcy Court granted Circuit City's summary judgment motion, sustained Circuit City's objection to Paramount's reclamation claim as a priority claim and reclassified the claim as a non-priority general unsecured claim. The Bankruptcy Court stated that reclamation rights are not self-executing and that Paramount had sat on its rights by failing to take the following actions to enforce its reclamation rights: (1) failing to seek relief from the bankruptcy automatic stay to enforce Paramount's rights in the goods that were subject to its reclamation demand; (2) failing to object to the proposed DIP financing that granted the secured party a floating lien on inventory, including Paramount's goods; and (3) failing to object to Circuit City's motion seeking approval of going out of business sales, which clearly included the liquidation of the goods subject to Paramount's reclamation claim. The court declared that simply following the reclamation procedures order and serving a reclamation demand was not sufficient to preserve Paramount's reclamation rights.

The Bankruptcy Court also ruled that Paramount would not have been granted relief on its reclamation claim, even if Paramount had timely taken action to enforce its reclamation rights. Paramount's reclamation rights were rendered valueless because the goods subject to Paramount's reclamation demand were encumbered by Circuit City's pre-petition lenders' floating lien on inventory on the petition date. Accordingly, Circuit City's secured lender was a "good faith purchaser" under the UCC with priority over Paramount's rights in the goods it sought to reclaim.

Furthermore, the Bankruptcy Court held that reclamation is an "in rem" remedy that under the UCC and the Bankruptcy Code would solely allow Paramount to seek the return of its goods and not take an interest in the proceeds of the goods once they were sold. The Bankruptcy Court also held that Paramount was not entitled to an administrative priority claim because Section 546 of the Bankruptcy Code, as amended by BAPCPA, does not require the Bankruptcy Court to grant an allowed administrative claim in favor of reclamation creditors.

Paramount Appeals

Paramount appealed the Bankruptcy Court's decision to the United States District Court. Paramount argued that it was entitled to relief on its reclamation claim because it had complied with both the statutory requirements for reclamation, as well as the reclamation procedures order. Paramount had timely served a written reclamation demand, which is all that it was required to do. Paramount also argued that requiring reclamation creditors to commence suit at the beginning of the bankruptcy case would create a race to the courthouse, which bankruptcy is supposed to prevent, and would unduly burden and create expense for both trade creditors and the debtor. Interestingly, one of the rationales asserted by Circuit City in support of the reclamation procedures order was that without the order, Circuit City would need to expend substantial time and limited resources contesting and litigating reclamation demands. Paramount also argued that once a reclamation demand was served, Circuit City was prohibited from disposing of the goods subject to reclamation, without obtaining an order from the Bankruptcy Court.

Circuit City asserted that reclamation is a state law remedy and that Section 546 of the Bankruptcy Code simply allows creditors to enforce such state law rights to the extent they exist. It argued that state law and courts across the nation have ruled that serving a reclamation demand is not sufficient without, in fact, pursuing such demand on a timely basis with sufficient diligence. Paramount forfeited its reclamation rights by not taking any further action, such as (1) seeking relief from the bankruptcy automatic stay to enforce its rights in the goods that were subject to its reclamation demand, (2) objecting to the proposed DIP financing, to the extent the DIP secured lender was granted a security interest in the goods subject to Paramount's reclamation claim, or (3) objecting to Circuit City's motion seeking the approval of going out of business sales that included Paramount's goods subject to reclamation.

The District Court's Decision

The District Court sided with Circuit City and held that Paramount should have diligently asserted its reclamation rights, especially in the context of such a large bankruptcy case like the Circuit City case, and it forfeited such rights by failing to do so. In fact, the District Court stated that Paramount's failure to take action in the manner enumerated above likely created more litigation and pressure on the Bankruptcy Court. Although Paramount served a reclamation demand, it failed to seek court intervention to "perfect" that right. In addition, Paramount's failure to take further action was fatal because, in the words of the Bankruptcy Court, the Bankruptcy Code is not "self executing." Once Paramount became aware that its goods were being pledged as collateral in connection with Circuit City's DIP financing facility, Paramount should have taken action. "To make matters worse," Paramount should have objected once it became aware that Circuit City was seeking permission to conduct going out of business sales, which undoubtedly included the sale of Paramount's goods.

The District Court did not consider whether Paramount's reclamation claim was deemed "valueless" because on the petition date, the goods that were subject to the reclamation demand were encumbered by Circuit City's prepetition lenders' floating lien on inventory; and whether Paramount's reclamation rights extended to the proceeds of its goods. The District Court, however, made clear that Section 546, as amended by BAPCPA, does not require granting an administrative expense if the Bankruptcy Court denies a reclamation claim, and even assuming the Bankruptcy Court has the discretion to award an administrative claim, the District Court did not believe the Bankruptcy Court erred in denying any relief to Paramount where Paramount had failed to diligently pursue its reclamation rights.

Conclusion

The United States District Court's decision in Circuit City is ample proof that reclamation has become a hollow remedy in bankruptcy cases. Even worse, as a result of the court's holding, a creditor who is not willing to incur the expense to enforce its reclamation rights at the beginning of the bankruptcy case, in what will likely be a losing effort, will lose those rights altogether. Where there are no reclamation procedures in place in a bankruptcy case, reclamation creditors should decide whether to act fast or risk losing their reclamation rights. If a debtor is proposing reclamation procedures, reclamation creditors should object to the procedures unless the procedures, like the procedures in the Advanced Marketing Services case, make clear that reclamation creditors will not be prejudiced by their failure to commence a reclamation lawsuit or seek injunctive relief to prevent the debtor from selling their goods, thus allowing reclamation creditors in such case the opportunity to fight another day.

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20-Day Administrative Claim

A right granted by the Bankruptcy Code is referred to as a 20-day administrative claim or §503(b)(9) claim. *For goods sold to a debtor in the ordinary course of business, and delivered within 20 days prior to the bankruptcy filing, that creditor is granted protection, separate and apart from its reclamation rights as a* **20-day administrative claim.** The creditor can assert an administrative expense claim for the value of the goods. The creditor is not required to send written notice, prove that the goods are still in the debtor's possession, or satisfy any of the other requirements mandated for a successful reclamation claim. The creditor must, however, prove that the goods were received by the debtor within 20 days before the onset of the case. The claim is not automatic and will be granted only upon notice and a hearing. The creditor generally will have to make an application in the bankruptcy court for allowance and payment of an administrative expense claim for the value of the goods. Administrative expenses are paid before most of the other creditors' claims, and are frequently, but not always, paid in full.

Alternatively, a debtor may request court approval of procedures for handling reclamation and administrative claims. If a court order is entered providing such procedures, it is the creditor's responsibility to follow the procedures to obtain more favorable treatment of its claim. In some jurisdictions, local rules of the court set deadlines for when the 20-day administrative claim must be asserted.

Discharge and Dischargeability

The goal of any bankruptcy proceeding is the discharge of some or all of the debtor's debts and obligations. A **discharge** *is a permanent order that releases the debtor from personal liability for certain specified types of debts, thereby releasing the debtor from any legal obligation to pay any discharged debts.* The Bankruptcy Code allows for a debtor to be denied a discharge completely in Chapter 7 for reasons including fraud, perjury, concealment of assets, or destruction of relevant records.

Reasons for Denial of Discharge in Chapter 7 Cases

- Corporations are not normally discharged, although they may be under Chapter 11.
- Concealing assets.
- Failure to keep records.
- Perjury in connection with the bankruptcy case.
- Failure to explain disposition of assets.
- Failure to obey court orders to testify.
- Prior discharge in bankruptcy within eight-year limit.
- Waiver of discharge by the individual debtor.

Certain debts are excepted from the discharge, but only upon action by the bankruptcy court. The following is a checklist of excepted debts:

- Taxes due less than three months before filing bankruptcy.
- Credit obtained by false financial statement or fraud.
- Unlisted creditors (not in every case).
- Breach of fiduciary duty claims.
- Intentional torts/conversion of collateral.
- Fines and penalties/taxes.
- Student loans.
- Driving Under the Influence (DUI) liabilities.
- Debts excepted from discharge in prior bankruptcy proceedings.
- FDIC claims.
- Securities law violations.

In order to have a debt excepted from a discharge under Bankruptcy Code §523 or to deny the discharge generally under Bankruptcy Code §727, a creditor, the trustee or the U.S. Trustee must file a timely complaint under one of those sections. A complaint to deny discharge under 11 U.S.C. §727 may be filed up to the conclusion of the hearing on confirmation of the Chapter 11 plan.

Pursuing Claims for False Financial Statements and Fraud

Trade credit professionals should be familiar with the provisions of Bankruptcy Code §§523(a)(2)(A) and 523(a)(2)(B) relating to fraudulent misconduct and the use of false financial statements.

Debts arising from the extension, renewal or refinancing of credit obtained through false pretenses, false representation or actual fraud are excepted from the discharge under Bankruptcy Code §523(a)(2)(A). Creditors must show that the debtor made a false representation or committed fraud, that the debtor was aware of the false rep-

resentation or fraud at the time it occurred, that the debtor intended to deceive the creditor, and that the creditor relied upon the misrepresentation with the resultant loss.

Under Bankruptcy Code §523(a)(2)(B), the Bankruptcy Code excepts from discharge claims arising out of the use of a materially false financial statement in writing. The creditor must show that the debt arises from the use of a false written financial statement that is materially false regarding the debtor's financial condition that the debtor caused to be published with intent to deceive. Conversions of collateral require showing a willful conversion of the proceeds, which is not easy to prove.

The Trustee's Strong Arm and Avoiding Powers

To further the equitable distribution of assets to creditors, bankruptcy trustees have the power to recover certain fraudulent transfers, recover preferential payments to creditors, and avoid certain improperly perfected security interests and mortgages. Collectively, these rights or powers are referred to as the trustee's strong arm and avoiding powers. Trade creditors want to make sure that any payments they receive are not subject to recovery as a preference, fraudulent transfer, or otherwise. It is the fiduciary duty of the creditors' committee to make sure that the debtor presses all possible claims for recovery, including preferences or fraudulent transfers that benefit insiders.

Basic Recovery Procedure

For both Chapter 7 and Chapter 11 filings, the procedure for recovering preferential and fraudulent transfers and setting aside improperly perfected security interests requires the filing of an adversary proceeding under Rule 7001 of the Federal Rules of Bankruptcy Procedure. Once the adversary proceeding is filed, the trustee or debtor in possession can obtain nationwide service of the summons and complaint pursuant to the Federal Rules of Bankruptcy Procedure. If the defendant does not answer the complaint within the time specified by the bankruptcy court, a default judgment will be entered. Once the defendant files an answer, an adversary proceeding is handled as any other lawsuit. If no jury has been demanded, the bankruptcy court tries the proceeding.

Settlement Considerations

As in any litigation, credit professionals should watch the bottom line: What will the action by the debtor or the creditors' committee bring into the bankruptcy estate for distribution to unsecured creditors?

The Trustee's Strong Arm Powers

Bankruptcy Code §544, the **strong arm clause,** *empowers a trustee or a debtor in possession to avoid any lien or security interest in personal property or any lien or mortgage on real estate which is not properly perfected as of the date of the bankruptcy petition.* Bankruptcy Code §544 grants to the trustee the rights of three different hypothetical types of creditors or purchasers:

Hypothetical Judicial Lien Holder

This allows the trustee or debtor in possession to set aside any security interest or mortgage of creditors for the benefit of all creditors. Trade creditors that advance credit through the sale of goods should understand the purchase money security interests and their special protection under both the UCC and the Bankruptcy Code. Any security interest or lien not properly perfected as of the date of the bankruptcy filing is subject to attack under Bankruptcy Code §544(a)(1).

Unsecured Creditor

The trustee has the rights of any actual creditor with an allowed unsecured claim as of the date of the petition permitting the trustee to set aside an improper bulk transfer of the debtor's property, located in states with a bulk

sale statute, or a fraudulent conveyance under state law. This allows the trustee to take advantage of the longer state law statute of limitations for fraudulent conveyance actions, rather than the shorter period provided in §548.

Bona Fide Purchaser for Value of Any Property Owned by the Debtor as of the Date of the Petition

This gives the trustee priority over the holder of an inaccurate or unrecorded deed or mortgage. When a debtor has a large business involvement in real estate and files for bankruptcy before all business is recorded, there may be a substantial recovery of assets for general unsecured creditors. In most states, a judgment lien or a *bona fide* purchaser for value takes priority over any improperly recorded deed, mortgage, deed of trust or other real estate encumbrance.

Legal Audit

Persons dealing with security interests and mortgages in personal and real property will want to be sufficiently familiar with the law governing the creation and perfection of security interests and mortgages to perform a legal audit or review of either their own documentation or documentation of lending creditors in a case. A **legal audit** *is a review of all documentation to determine whether all security interests were properly perfected and all mortgages were correct and properly recorded, paying special attention to legal descriptions of the covered real estate*.

Preferences

A **preferential payment,** *which refers to a creditor who gets paid before dividing the assets equally among all those to whom it owes money, often by making a payment to a favored creditor just before filing a petition to be declared bankrupt,* to an unsecured creditor can be recovered by the trustee under Bankruptcy Code §547. To prove a preference, the trustee or the debtor in possession must prove that a transfer of the debtor's assets was made:

- To or for the benefit of a creditor.
- For or on account of an antecedent debt.
- While the debtor was insolvent.
- Within 90 days of the petition for relief, or within one year if the transfer was to an insider.
- The effect of the transfer was to give the creditor more than the creditor would otherwise receive in a Chapter 7 liquidation.

Exceptions to the Preference Rules

- A transfer to a creditor that is intended to be and is contemporaneous with the extension of credit or the delivery of goods by the creditor.
- Subsequent new value is given to the debtor after receipt of payment.
- Payment in the ordinary course of business or financial affairs of the debtor and the creditor; or made according to ordinary business terms.
- Preference actions for recovery of less than $6,425 cannot be pursued.
- Preference actions to recover less than $12,475 can be commenced only in the district court for the district where the trade creditor is located.

Comprehension Check

Before a **preferential payment** to an **unsecured creditor** can be recovered, what must the **trustee** prove?

What are the exceptions to the preference rules?

Fraudulent Transfers

Two types of **fraudulent transfers** made within two years of bankruptcy may be set aside under Bankruptcy Code §548 (a) and (b). *The transfer of the debtor's property made with the actual intent to hinder, delay, or defraud creditors* is one type. The debtor's intent is usually inferred from the circumstances of the transfer. If the court concludes the debtor had the necessary fraudulent intent, it will usually set aside the transfer unless the debtor can prove it received an equivalent value in money or money's worth for the asset transferred. The second type is *the transfer of property for less than market value at a time when the debtor was insolvent or under capitalized.* However, under the Bankruptcy Code, a transferee that takes for value and in good faith is entitled to a lien on the property transferred or may retain any interest transferred to the extent that such transferee gave value.

Comprehension Check
What is a **fraudulent transfer?**

Involuntary Bankruptcy

The filing of an involuntary bankruptcy is used by creditors for several reasons. Often, an involuntary bankruptcy is the only way to force the debtor to provide full financial disclosure. Creditors may also want to force recovery of fraudulent and preferential transfers. As the common law does not prevent a debtor from preferring one creditor over others and gives creditors only a limited ability to recover fraudulent transfers, the filing of an involuntary bankruptcy may be the only way of stopping and recovering these types of transfers.

An **involuntary petition** may be filed by creditors only under Chapter 7 or 11. To do so, *three creditors must have noncontingent, undisputed claims.* The Code has emphasized that a petitioning creditor's claim must not be subject to a *bona fide* dispute in either liability or amount. Three creditors are generally necessary to file an involuntary petition. For debtors with 12 or more unsecured creditors, the three creditors' unsecured claims must aggregate at least $15,775 (subject to increase for inflation) in order to force an involuntary bankruptcy. The involuntary petition is served upon the debtor together with a summons in the same manner in which an adversary proceeding would be commenced. Normally, a debtor has 20 days to contest an involuntary petition. Typically, the petitioning creditors must demonstrate that the debtor is generally not paying its undisputed debts as such debts become due.

Strategy

Creditors should accept all payments offered by a debtor in financial difficulty. The worst that can happen is the creditor may have to return the money if it is later deemed to be preferential. The trustee or creditors' committee should carefully review all the debtor's security agreements and transfers for the year prior to the bankruptcy filing to rule out possible fraudulent transfers that might be set aside. It is important to evaluate the bankruptcy case at the beginning so as not to use up the assets of the estate in legal and other fees to the detriment of the unsecured creditors.

Beginner's Guide to Bankruptcy*

First Things First

How Do I Confirm It?

What do I do? Find out if the information is true and accurate or simply a rumor.

> **Tip:** Verification is extremely important as there are strict legal consequences for attempting to collect a debt if a bankruptcy has been filed.

PACER (Public Access to Court Electronic Records). PACER is an electronic access service that allows you to get case information directly from bankruptcy courts. Requires login and password. https://www.pacer.gov/.

Google search. Why not? Google knows all!

> **Tip:** Pay close attention to the filing date! This will dictate other rights such as potential preference issues (having to send money back) and reclamation (trying to get your stuff back).

Get Your Ducks in a Row!

Do we have orders pending or in transit?

Yes? If you were paid up front, good for you! If not, you should consider cancelling or rerouting those shipments back to your warehouse. If already delivered, you may have a chance to reclaim your material.

No? Mark the account for non-shipment.

> **Tip:** If you have a contract in place, you need to explore what your options are before you cancel, but you may want to seek legal counsel first.

What does the account look like? People are going to ask a lot of questions so you need to be ready. Gather the proper documentation, to include two years of account records on:

- ✓Delivery tickets (bills of lading, proof of delivery), credit application, guarantee and current statement. This is the start of it, but you will need all the info below retained for later consideration.
- ✓Payment information such as check remittance copies, ACH/wire receipts, etc.
- ✓Invoices (paid and unpaid) and a statement of account.
- ✓Purchase orders which could be emails, voicemail, fax, etc.
- ✓How much do they owe you?

Who Do We Need to Tell?

The Big Dogs. This will include notification to salespeople, managers, CFOs and others in your credit department (including other branches).

Your Peers. Luckily, NACM can help with this process. Visit NACM's portal, they will verify and then send out notification to others in your industry group.

Watch Out for the Automatic Stay!

What is it? The automatic stay or "stay" bars you from all collection efforts. The automatic stay is put in place immediately after filing and there is no notification sent to anyone. The automatic stay protects the debtor and its

property, stopping actions by creditors to collect on prepetition debts (any amounts owed prior to the filing) or litigation. Think of it as a shield that is put into place between you and the debtor as soon as the bankruptcy petition is filed. The automatic stay applies to all chapters of bankruptcy.

What does it mean to me? Collection efforts halt! The following can be considered collection efforts: demand letters, statements, phone calls or invoices sent by email or fax. As soon as you know about the bankruptcy, stop all efforts to collect any prepetition amounts owed by the debtor or you will be in violation of the automatic stay (technically notice of the bankruptcy is not required for these efforts to constitute a stay violation).

Can the stay be removed? In some situations a creditor can ask the court to lift the stay. Common reasons to do this would be: debtor is behind on home mortgage payments, automobile payments, failed to maintain insurance on home or vehicle or has a non-dischargeable debt such as alimony, child support, or other debt the debtor has agreed to reaffirm. If the stay is lifted, the creditor can proceed with certain actions that would otherwise be prohibited by the automatic stay.

Am I someone that can request a lift? Under certain circumstances, a creditor can ask the court to "lift" the stay. For example, if you have a lien on the debtor's property and the debtor owes you more than the value of the property, you can ask the court to lift the stay. Otherwise, get in line.

How do I get the lift? A motion is required to be filed with the court. Your next step is to contact your attorney to file a motion (with the presiding court) explaining in detail why you are requesting the lift.

Exceptions to the automatic stay. If a debtor is filing the second bankruptcy within a year, the automatic stay applies only for 30 days unless extended by the court. If a debtor is filing a third time within a year, the automatic stay goes into effect only by the request of the debtor, if the third filing was in good faith.

Tip: Courts take the automatic stay very seriously. There are consequences for failure to abide by these rules. Violation of the automatic stay can lead to contempt of court.

Expiration of the stay. With respect to acts against property of the estate—the stay expires when property no longer belongs to the estate. With respect to the debtor—the stay expires the earlier of when the case is closed or when the case is dismissed.

Tip: There are many exceptions and caveats to the automatic stay. If you have further questions regarding this, seek legal counsel.

Reclamation

What is it? Think of reclamation as a way to "reclaim" the goods that you sold on credit. Once the goods have been delivered or paid for, title has transferred. But, the Uniform Commercial Code (UCC) defines a process to get your goods back in the event of insolvency. The caveat is that successful reclamation requires cooperation with the debtor, who is already in bankruptcy and most likely unwilling to help.

What does it mean to me? Both the UCC and the Bankruptcy Code provide very clear direction on the reclamation process. What you can and cannot do is spelled out for you. Under the UCC, it is the seller's right to demand that an insolvent (defined as liabilities are greater than assets) buyer return goods purchased on credit. A seller can reclaim goods delivered to a buyer if the seller satisfies the following conditions:

- ✓The goods were shipped on credit.
- ✓The buyer was insolvent at the time it received the goods.
- ✓The seller demands return of the goods within 10 days of the buyer's receipt of the goods.
- ✓The buyer is in possession of the goods when the seller made the reclamation demand.

Reclamation in bankruptcy. It is important to understand that reclamation rights continue under Section 546(c) of the Bankruptcy Code. Section 546(c) requires a written reclamation demand and expands the reclamation reach-back

period to 45 days from the above mentioned 10 days. Note that reclamation rights are subject to any lien on the property sought to be reclaimed.

What do I do? Determine if you have sold them anything on credit in the last 45 days.

If your answer is No. Get to the back of the line.

If your answer is Yes. Your "Reclamation Letter" should follow the guidelines below:

- ✓State that it is a demand for reclamation.
- ✓Identify the goods subject to the reclamation and include copies of invoices and purchase orders.
- ✓Demand an inventory of the goods on hand and make sure they segregate them until return transportation is arranged.
- ✓Send letter through email, fax and certified carrier to include a signed return receipt.
- ✓For a sample demand letter see NACM's Manual of Credit and Commercial Laws.

What has to be on the other side for this to work?

- ✓The buyer has to have your goods.
- ✓Goods have to be identifiable as yours.
- ✓Goods cannot be altered or processed (must look as shipped).
- ✓Goods are not subject to a lien.

Tip: Once a customer files bankruptcy, a reclamation demand must be sent within 20 days or reclamation rights are lost. Best practice is to send the demand as soon as possible because reclamation rights are only valid if the debtor still has the goods.

Demand Deadlines. The 45-day reach-back period is based on the physical receipt of goods, for instance when the goods are delivered and signed for.

Tip: To compute the 45-day reach-back period begin counting backward starting the day before filing date. If your goods were received (title transferred) during this time, then they fall within your reclamation rights.

Early Case Considerations

Priority Administrative Claims Section 503 (b)(9)

Are you a supplier of goods or services? If the answer is goods, keep reading here. If the answer is services, you will not have a priority administrative claim.

What is it? Section 503(b)(9) elevates all or a portion of the goods supplied to the debtor 20 days prior to the bankruptcy filing from a low priority general unsecured claim to a higher priority administrative claim. The goods must be sold in the ordinary course of business.

What does it mean for me? The 20-day portion of your claim has a much better chance of being paid in full. While secured creditors still retain priority over your §503(b)(9) claim, it's still much better than being a general unsecured creditor. Unlike a reclamation claim, a §503(b)(9) claim is still available even if a secured creditor has a lien on the goods you shipped and if the debtor has already sold the goods.

What do I do? You must file a motion for allowance and payments of your §503(b)(9) claim. Always consult counsel for assistance with these filings.

Tip: Check the local rules and any orders in the bankruptcy case that permit or require the filing of §503(b)(9) claims by proof of claim form rather than by motion.

The Creditors Schedule

What is it? A debtor must provide a list of all known creditors when filing a petition for bankruptcy. You may or may not be a known creditor. It is important to verify that you have been listed as a creditor, your company is listed accurately and the amount owed is correct. If you are not listed as a creditor and do not have notice of the bankruptcy filing, it may preserve your right to continue collection action. Talk to your legal counsel

What do I do? You should obtain a schedule of creditors in the bankruptcy case. You can find the court filings through PACER, or your attorney can get them.

The Proof of Claim

What is it? A proof of claim (POC) is your way of notifying the court that you're owed prepetition debt. The actual POC form is a written statement that notifies the bankruptcy court, the debtor, the trustee, and other interested parties that a creditor wishes to assert its right to receive a distribution (pay out) from the bankruptcy estate.

What does it mean to me? You need to decide if you're going to file a POC. There will be a notice sent telling you to file a proof of claim and list a deadline (bar date) to get your claim filed or not to file a proof of claim. In most Chapter 7 and Chapter 13 bankruptcy cases where there are assets to distribute, creditors must file a proof of claim in order to get paid.

What do I do? File a claim because failure to do so will result in no distributions, if there are any.

What to attach. All supporting documentation to support the basis and amount of the claim, including any applicable contracts, invoices, purchase orders, account statements, and security interest (if secured), etc. Do not send originals. Take copies of the documents and keep a copy for yourself as well.

Tip: Be aware of the deadline because late-filed claims may not be allowed.

If your claim is an unsecured debt. To see a sample proof of claim go to: http://www.uscourts.gov/forms/bankruptcy-forms/proof-claim-0. A creditor may file a proof of claim on its own, but some may wish to consult with legal counsel.

Do I qualify as a critical vendor? Ask yourself, will the debtor survive without you (or at least your goods and services)? If yes, skip ahead to critical vendor discussion.

If your claim is a secured debt. If your debt is secured or you think you deserve priority status, the proof of claim may be more complex and you might wish to consult legal counsel. Understanding how to prepare and file a proof of claim is critically important for any creditor.

- **Where do I send the claim?** Typically, you will send this to the clerk of the bankruptcy court where the filing is held, or in some cases, to a claims agent that may be appointed (which can be determined by looking at the case docket).
- **How do I send the claim?** It is recommended that you submit your claim via reputable carrier (UPS/FEDEX) with tracking to ensure timely delivery.

Tip: A claim is only considered timely if it is actually received by the claims bar date.

Don't file a claim. If you receive notice not to file a proof of claim, it has been determined that no assets have been discovered yet to make a distribution to creditors. If assets are discovered, you will receive a notice setting a deadline to file a proof of claim.

Tip: New rule: Supporting documents must be attached. Exception: If supporting documents have been lost or destroyed, attach explanation of circumstances.

Fight or Flight

What does this mean to me? You need to weigh the amount of your claim with the anticipated legal fees if represented by counsel. Administrative and legal expenses can be costly, especially in complex Chapter 11 cases.

What do I do? You need to identify which chapter of bankruptcy you're dealing with. The chapter will help determine the likelihood of any recovery (Chapter 7, 11 or 13):

- **Liquidation (Chapter 7).** Filed by individuals or companies. Creditors must file a proof of claim in order to be eligible for a distribution.
- **Reorganization (Chapter 11).** This is the most common type of business filing. It is a reorganization of the business. It can result in a plan or a sale of assets, among other results. The company remains in control of its assets and has all rights of a trustee. If the creditor is listed on debtor's schedules in a Chapter 11 bankruptcy and creditor agrees with amount listed by debtor as being owed, creditor does not need to file a proof of claim (unless the creditor's claim (i) is listed on the schedules as disputed, unliquidated or contingent, or (ii) is not listed on the schedules, in which case the creditor must file a proof of claim in order to be eligible for a distribution).
- **Repayment (Chapter 13).** This is filed by individuals who retain assets and pay creditors over time under a structured plan.

Tip: The main difference between Chapter 7 and 13 is that in Chapter 7 the property of the estate is whatever debtor had at the time of the bankruptcy filing. In Chapter 13, the property of the estate includes any property obtained by the debtor after bankruptcy filing until the time plan is confirmed.

What do I do? You need to determine if the debt is secured or unsecured. In other words, how is the debt classified by the court? Once you've classified your debt, make a final decision on how to proceed with filing your claim with the court.

Secured. This has the benefit of a security interest over some or all of the assets of the debtor. Was the security interest perfected over 90 days prior to bankruptcy? You get paid first (even before the lawyers). File a claim.

Unsecured. This does not have the benefit of any security interest. Typically, but not always, it is paid less than full value and pro rata with other unsecured creditors. See prior section on §503(b)(9) claims how your unsecured claim can be elevated to a priority administrative unsecured claim. Elevating all or a portion of a supplier's claim from a low priority general unsecured claim to a higher priority administrative expense claim gives a better chance for a payout.

Critical Vendors

What is it? Critical vendors are those that are essential to the bankrupt business's survival in Chapter 11. In other words, you're supplying a product or service so important to the debtor's business operation that without it, the debtor would fail to reorganize.

What does it mean to me? If you supply a product or service that is so critical to the debtor's operations that finding a replacement vendor would be overly burdensome on the debtor, the bankruptcy court may grant you critical vendor status. If you supply a product that is easily obtained from any other vendor, it is unlikely that the court will grant your critical vendor status. The benefit to becoming a critical vendor is that you can obtain payment in full of your prepetition claim. It also is a likely indicator that your relationship will survive a sale of the debtor's assets and that your contract (if you have one) potentially will be assumed by the buyer. Often, however, as a quid pro quo for payment of your prepetition claim, you will be asked to extend the same credit terms as they had prior to the bankruptcy. This frequently is done through execution of a critical vendor contract which often provides that your critical vendor payment will be subject to clawback if you "misbehave" (i.e., revoke credit terms without justification). In addition, critical vendors rarely are given a preference waiver, so any payments you received in the 90 days prior to the debtor's bankruptcy filing may still be subject to recovery by the debtor (subject to any preference defenses you may have).

How to get selected as a critical vendor? To be considered a critical vendor, the debtor must file a motion with the bankruptcy court and prove to the judge that a creditor's products are necessary to the survival of the business and difficult or impossible to get from other vendors. If the debtor is able to carry this burden, then it will be authorized to pay its critical vendors in full.

In order to grant a supplier critical vendor status, courts look at several factors:

- ✓Debtor needs particular products for the company to survive.
- ✓Vendor likely would stop selling the debtor absent payment of its prepetition claim.
- ✓Whether payment to critical vendors (and therefore continued supply from those vendors) would increase the likelihood of a successful reorganization.

Tip: Tread lightly when discussing critical vendor status because if you approach the debtor, it can be deemed a violation of the automatic stay.

Creditors' Committee

What is it? Are you one of the largest unsecured creditors? If so, you might consider becoming a member of the creditors committee. The unsecured creditors' committee is appointed by the U.S. Trustee, in a Chapter 11 case, and is made up of the largest unsecured creditors (usually seven, but sometimes fewer) of the debtors who are willing to serve. Committee members have a more active role than other creditors and have greater access to information and to the debtor's representatives. The committee represents the interests of all unsecured creditors in a fiduciary capacity.

What do I do? A creditors' committee must first be formed. The U.S. Trustee owns the process of forming the committee.

- The U.S. Trustee may appoint a committee as soon as possible after the bankruptcy case is filed if there is significant interest among unsecured creditors.
- The process begins with the U.S. Trustee sending a questionnaire to the largest unsecured creditors. Creditors interested in becoming a member of the committee complete and return the questionnaire to the U.S. Trustee. From that point, the U.S. Trustee convenes an in-person meeting of those creditors that are interested in serving. The trustee will select members of the committee from among those who submitted questionnaires and are present at the meeting (although sometimes this is done based on the questionnaires alone without an in-person meeting).

What does it mean to me? The committee has official duties and responsibilities. There is a time commitment involved with being a committee member.

- ✓Review the progress and status of the case and discuss the same with the debtor. Also, the debtor is required to file periodic financial reports with the Court and the Office of the United States Trustee. These reports should provide valuable information for the committee.
- ✓Investigate the financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of the business.
- ✓Participate in the formulation of a plan.
- ✓Ask the Court to appoint an examiner in the case. An examiner is a professional (often a CPA) with the expertise to investigate the business and file a report drawing conclusions regarding the viability of the same, the competence of past or current management, possible fraud, etc.
- ✓Request the appointment of a trustee. A trustee is an independent third party charged with the responsibility of controlling estate assets.

✓Ask the Court to either dismiss the case or to convert it to one under Chapter 7 (liquidation). One cause for dismissal or conversion is unreasonable delay which is prejudicial to creditors.

What must the debtor do? The Bankruptcy Code provides further that the debtor must meet with the creditor's committee to transact such business as may be necessary and proper, and that the debtor shall furnish to the committee, upon request, information concerning the debtor's business and its administration. If in the performance of its duties, the committee would be aided by the services of an attorney, accountant or other professional, the Bankruptcy Code provides a means for the appointment of such individuals as may be selected by the committee. The compensation of such individuals will be paid from assets of the debtor's estate, and will not be chargeable directly to individual committee members.

Considerations Throughout the Entire Case

Post-Petition Sales

What is it? Some creditors may decide to sell to a debtor after they've filed Chapter 11 bankruptcy. The debtor in bankruptcy, known as a **Debtor in Possession (DIP)**, is now essentially creating new debt that is not part of the bankruptcy case.

What do I do? Vendors need to manage their post-petition credit risk very closely. Due to the possibility that a debtor may have limited cash flow through the bankruptcy process, vendors may want to consider whether to continue doing business, and if so, under what terms. Steps in determining a debtor's post-petition liquidity include searching PACER to determine whether the debtor has authority to use its lenders cash collateral or has obtained DIP financing. This information might help you as the creditor feel more comfortable with the debtors' ability to pay you for post-petition shipments. In addition, if the debtor fails to pay you for any post-petition shipment you are entitled to a higher priority administrative claim for those shipments (although there is no guarantee administrative claims are paid in full). If you are not comfortable extending credit post-petition, you can impose COD or cash in advance terms or elect not to ship at all.

Preference Claims and Fraudulent Transfers

What is it? Preference and fraudulent transfer actions are some of the most common bankruptcy-related claims that creditors face. It may not seem fair, but it's a reality of bankruptcy. The U.S. Trustee will review all payments made to creditors going back 90 days from the date of filing. Any transfer (payment) made by the debtor to the creditor will be analyzed by the trustee. The intent of preference and fraudulent transfers analysis is to prevent a debtor from "preferentially" paying one creditor over another or "fraudulently" transferring assets to another party. The concept is rooted in fairness.

What does it mean to me? No creditor wants to receive a preference action. Nonetheless, you have to deal with it. You may receive a "demand letter" from the U.S. Trustee. The demand letter lists the payments that the trustee or debtor in possession identifies as having been made to you within the 90-day period. The demand is for immediate payment, usually less some small discount. When a creditor receives a preference demand letter, the creditor should always have experienced bankruptcy counsel review the case to determine whether the creditor has valid defenses.

Tip: Creditors often are concerned about taking payments from their customers when the customer is known to be headed into bankruptcy. The reason is that the payment might be subject to clawback as a preference. Consider, however, that it often is better to have the money in-hand for several reasons: (1) you have use of the money, (2) the burden is then on the trustee to come after you to try to recover it as a preference, and (3) you might have defenses to a later preference claim. As it is often said, "possession is 9/10ths of the battle!" So, take the payment.

What do I do? You have to defend the preference action. The trustee or debtor in possession has the initial burden of proving that the elements of a preference exist. For starters, a prepayment is not a preference (even if the prepayment was received within the 90 days before bankruptcy). The Bankruptcy Code provides defenses to preference

actions. The three most common are all "affirmative defenses," meaning that the creditor has the ultimate burden of proof on these issues. The most common defenses used by creditors are:

- **Ordinary course of business defense.** This defense is highly subjective, but the most common methodology is to look at the debtor's payment history to evaluate its average time to pay your invoices for some period of time prior to the 90-day preference period. Did the timing stay consistent before and during the 90-day preference period? You may also use the average time for payment in the relevant industry to prove the ordinary course of business defense. What is the typical payment timing for other companies in the same industry? Depending upon the court, the relevant industry might be the creditor's or the debtor's industry, if they are different.
- **Contemporaneous exchange for new goods or services defense.** The creditor proves the "contemporaneous exchange" defense by showing that the creditor provided new goods or services contemporaneously (i.e., at or near the same time) with a payment that was of equal value to the goods or services provided and that the parties intended the transaction to be a "contemporaneous exchange." For example, if the creditor delivers goods worth $100 on June 1 and is paid $100 for those goods on June 2, so long as the parties intended the $100 payment to be for the $100 in new goods and intended that the payment would occur "substantially contemporaneously" with delivery of the goods, then the contemporaneous exchange defense applies.
- **New value defense.** This defense gives you credit for goods that you ship during the 90-day period after you have received an otherwise preferential payment. The value of any "new" goods or services shipped during the 90-day period after an otherwise preferential payment can be offset dollar-for-dollar against any prior preferential payments made by the debtor. In order to use this defense, most courts require that the later shipment remain unpaid, although some courts will count the later shipment as new value even if you have been paid for that shipment. Using a simple example, this defense works as follows: you receive a $10,000 payment on day 80 prior to the bankruptcy filing and ship $7,500 of new goods (for which you were not paid) on day 70 prior to the bankruptcy filing. Under this scenario, assuming that the $10,000 payment meets all of the elements of a preference and would otherwise be avoidable by the trustee, you are entitled to offset the $7,500 shipment such that your net exposure is $2,500. This defense is much more objective than the ordinary course of business defense.

Tip: They have two years from the date of filing to file a preference lawsuit.

Existing or Executory Contracts

What is it? An executory contract is a contract that has not yet been fully performed, that is to say, fully executed. Put another way, it's a contract under which both sides still have important performance remaining, even if your customer is in bankruptcy.

What does it mean to me? If you are a party to a prepetition contract (executory contract), debtors and bankruptcy trustees are authorized to "assume or reject" these contracts in bankruptcy.

Are you serious? Yes, property interests of the debtor filing for bankruptcy become property of the estate. An executory contract is property of the bankruptcy estate.

Why? The Bankruptcy Code allows debtors to shed (i.e., reject) burdensome contracts (e.g., those where the debtor is paying more than current fair market value) and to retain (i.e., assume) beneficial contracts.

How? Only with bankruptcy court approval can the debtor "assume or reject" an executory contract. As a party to an executory contract, the debtor is required to send you notice of a motion seeking authority to assume or reject your

contract and you are given an opportunity to object, if appropriate. Bankruptcy courts defer to the debtor's business judgment when deciding whether to permit assumption or rejection of an executory contract.

What does assumption mean for me? A debtor may assume an executory contract by: Obtaining an order from the bankruptcy court permitting assumption of such contract after notice and an opportunity for the non-debtor counterparty to be heard in the bankruptcy court, or confirming a plan of reorganization, which provides for assumption of the contract. If your contract is assumed, you are entitled to a cure of all defaults (with limited exceptions). This means that if you are owed money under a contract for prepetition sales, if your contract is assumed, you will receive payment in full of your prepetition claim (as opposed to payment of some cents on the dollar).

What does rejection mean for me? Rejection of an executory contract is essentially the debtor's declaration that it will not perform its remaining obligations. Upon rejection, the debtor no longer can be compelled to perform.

What do I do? If you receive a notice that the debtor is seeking to assume your contract, it should include what the debtor believes is the amount needed to cure any defaults. You should review this carefully to be sure that you agree with the amount. If you do not, you will want to retain bankruptcy counsel who can file an objection for you to assert the correct cure amount.

What if the debtor rejects the contract? If you receive a notice that the debtor is seeking to reject your contract, first consider whether it is a leverage play by the debtor to try to get you to renegotiate the terms of your contract in exchange for continued business. If the contract is one you would prefer not to lose, you might wish to contact the debtor to see whether negotiations are possible. But know that it is ultimately the debtor's right to reject your contract. If your contract is rejected, you are entitled to file a "rejection claim." The order authorizing the rejection or a subsequent notice should tell you the deadline to file your rejection claim. A rejection claim is a claim based upon the debtor's breach of your contract, which is what is deemed to have happened upon rejection. It is as though you are filing a lawsuit in state court against the debtor seeking damages for the debtor's breach, but instead are asserting those damages in the form of a rejection claim in the debtor's bankruptcy case. The rejection claim is treated as a general unsecured claim.

Monitor, Monitor, Monitor!!

What do I do? Be cautious and monitor all filings and due dates. Late or misfiled paperwork can cost you the **entire** amount of your claim.

> **Tip:** Most proceedings take months and sometimes years to unwind. Use this time to read up on bankruptcy proceedings so next time, you will be ready.

**Excerpted from NACM's Graduate School of Credit and Financial Management project, 2016. Adam Easton, CCE; Alejandro Ojeda-Nonzioli, CCE; Eve Sahnow, CCE; Jessica Pierre, CCE; Kevin Quinn, CCE; Tawnya Marsh, CCE; Jason M. Torf, Esq.; Ryan L. Haaland, Esq.; Holly C. Hamm, Esq.; and The Meridian Group.*

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Comprehension Check

1. Provide a brief definition of the following chapters of the Bankruptcy Code:
   a. Chapter 7
   b. Chapter 9
   c. Chapter 11
   d. Chapter 12
   e. Chapter 13
   f. Chapter 15
2. What is the purpose of an **automatic stay** in bankruptcy?
3. What are the basic duties of a **trustee?**
4. In a Chapter 7, **trustees** must satisfy claims in a particular order. List the priority of claims in order.
5. What is the purpose of Chapter 11?
6. Who are the key players in a Chapter 11 proceeding?
7. What is the role of a **creditors' committee** in a Chapter 11 proceeding?
8. How long does a debtor have to assume or reject **executory contracts,** with court approval, under a Chapter 11 proceeding?
9. Define the term **claim,** under the Bankruptcy Code.
10. How is a **small business** defined under Chapter 11 of the Bankruptcy Code?
11. How are claims classified under the Bankruptcy Code?
12. What information is contained in a **plan of reorganization?**
13. In order for a **plan of reorganization** to be accepted, what is necessary?
14. What is the **absolute priority rule?**
15. What two conditions must a plan satisfy under Chapter 12?
16. List the three criteria for filings under Chapter 13.
17. Why is it important to establish a systematic response system for bankruptcy cases?
18. Under what chapters of the Bankruptcy Code must a proof of claim be filed?
19. Before a **preferential payment** to an **unsecured creditor** can be recovered, what must the **trustee** prove?
20. What are the exceptions to the preference rules?
21. What is a **fraudulent transfer?**

Summary

- The Bankruptcy Code is federal law that provides an organized procedure under the supervision of a federal court for dealing with insolvent debtors. This became law in 1979. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) is the most recent update of bankruptcy law that establishes rules governing bankruptcies for individuals, corporations, small businesses and farms, as well as multination debtors.
- Chapters 7, 9, 11, 12, 13 and 15 are chapters of the Bankruptcy Code that outline the filing of different types of bankruptcies. One of the most important things to know about Bankruptcy Code is the adherence to different filing deadlines because noncompliance can affect a creditor's rights under the law. If there are is any conflict between the provisions of Bankruptcy Code itself and the various applicable rues, the Bankruptcy Code always takes precedence.
- An **automatic stay** is immediately instituted when a bankruptcy petition is filed. Its purpose is to ensure the fair distribution of nonexempt, unencumbered assets among creditors. This resulting actions that are halted include:
  - Beginning or continuing judicial proceedings against the debtor
  - Obtaining possession of the debtor's property
  - Creating, perfecting or enforcing a lien against a debtor's property
  - Setting off indebtedness owed to the debtor that arose prior to the bankruptcy proceeding
- **Chapter 7** bankruptcy is the most common and involves liquidation. The debtor must satisfy a means test. During a Chapter 7 bankruptcy a trustee is appointed. The trustee has several legal obligations that include, but are not limited to, the following:
  - Sell any assets of the estate at the benefit of the creditor
  - Investigate the financial affairs of the debtor
- If a creditor wishes to participate in the distribution of the estates assets, the creditor must file a proof of claim. It indicates the amount of debt owed by the debtor.
- **Trustees** must satisfy all claims in a particular order. The order of priority includes:
  - Secured creditors
  - Administrative expenses
  - Involuntary expenses
  - Wages and compensation claims
  - Employee benefits plans
  - Grain producers or fisherman claims
  - Customer deposits
  - Taxes
  - Unsecured claims of a federal depository institutions regulator agency
  - Claims arising from the unlawful operation of a motor vehicle or vessel
  - Unsecured creditors
  - Preferred stockholders
  - Common stockholders
- A creditor that has any concern about how the case is being handled by the trustee has two options: retain counsel to object to the trustee's final report, or contact the U.S. Trustee for the district in which the case is pending.

- A petition for bankruptcy must be filed in the location where the principle business exists, or where the principle place that assets of the debtor have been held for 180 days or longer. Most petitions are initiated by the debtor, but may be filed by creditors under Chapter 7 or Chapter 11.
- The Bankruptcy Code gives all creditors the right to be notified about any actions that affect the operation of the business and the assets of the bankruptcy estate. Any post-petition unsecured credit obtained by the debtor outside the ordinary business operations must get approval from the courts.
- The U.S. Trustee forms a creditors committee. The financial stake of the committee members, as well as expertise in the industry, give them tremendous influence in the case. They are often the deciding factor for the plan to be confirmed. The committee must also provide access to information by all creditors. Many create websites to fulfill this rule, and the sites provide information like monthly committee reports, or access to the claims docket.
- **Chapter 11** allows a debtor to assume or reject an unexpired executory contract or lease if the court approves. The debtor has 120 days after the bankruptcy to assume or reject unexpired leases of nonresidential real property.
- Many Chapter 11 bankruptcies fail to reorganize and end up being converted to Chapter 7 bankruptcies or dismissed.
- A **plan of reorganization** incorporates a method of classifying claims, secured and unsecured creditors being put into separate classes. Creditors should examine the plans in order to see how classification affects their interests. Creditors may file objections to the classifications before the confirmation hearing, or earlier. **Plans** may include:
  - **Extension plans**
  - **Compromise plans**
  - **Partial payments**
  - **Debt for equity swap**
- In order for reorganization plans to be accepted, a majority from each class must accept the plan. The court is likely to confirm a plan if all classes of creditors and interest holders have accepted the plan with necessary majorities. The court, through a **cramdown**, also has the right to accept the plan even if one or more classes doesn't accept the plan.
- Chapter 11 bankruptcies may also come **prepackaged** (prepack) or **prearranged**. Prepacks make an agreement with all creditors, while a prearranged bankruptcy only makes an agreement with some creditors. There are several advantages to a prepack or prearranged Chapter 11 bankruptcy, such as shortening the timeframe of the bankruptcy process, lowering cost and fees, and limiting uncertainty. However, a prearranged Chapter 11 bankruptcy doesn't ensure that trade creditors receive full or any payment.
- **Chapter 12** eliminates the absolute priority rule, and the plans must satisfy two conditions:
  - Creditors are to receive what they would receive under liquidation (**liquidation test**)
  - All the debtor's disposable income for three to five years must be paid to creditors (**best efforts test**)
- The three criteria for filing a **Chapter 13** Bankruptcy include:
  - The debtor must be an individual
  - The debtor must have a regular income
  - The debt's limit is $494,725 in unsecured debt and $1,184,200 in secured debt. Thresholds are subject to periodic adjustment for inflation

- An efficient internal system for handling bankruptcy should be created. This includes the routing of bank notices so the information goes to the correct individual. Generally a proof of claim is required for Chapters 7, 12 and 13. In all cases, official proof of claim **Form 410** should be used. Objections to claims can be filed, but should be limited due to the administration costs associated with an objective, which inevitably is removed from the total amount available to unsecured debtors.
- The law provides for the protection of creditors who deliver goods to an insolvent debtor through the concept of reclamation. Goods subject to reclamation include those received up to 45 days prior to the bankruptcy filing. Creditors have up to 20 days after the filing to send a demand for reclamation.
- The goal of any bankruptcy proceeding is the discharge of some or all debtor's debts and obligations. Some reasons for denial of discharge under Chapter 7 cases include:
  - Corporations are not normally discharged
  - Concealing assets
  - Failure to keep records
- Certain debts are allowed to be discharged. Some of these debts include:
  - Student loans
  - Credit receive using false financial statements
  - DUI liabilities
- Before a **preferential payment** can be recovered the trustee or debtor must prove that a transfer of the debtor's assets was made:
  - To or for the benefit of the creditor
  - For or on account of an antecedent debt
  - While the debtor was insolvent
  - Within 90 days of the petition of relief, or within a year if it was to an insider
  - The creditor received more than it would have under Chapter 7 liquidation
- Often, involuntary bankruptcy is the only way to force the debtor to provide full financial disclosure.
- Creditors should accept all payments offered by the debtor in financial difficulty.

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