Business Bankruptcy

Executive Summary: Need to Know Bankruptcy Concepts

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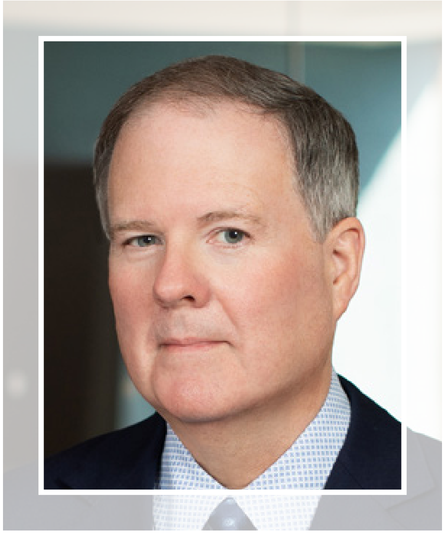

In this second part of his article (continued from December 2021), David explains more about understanding U.S. bankruptcy concepts...

Statutory Liens

Vendors in possession of goods belonging to a debtor may be able to assert a valid possessory lien under state law. The Bankruptcy Code recognizes these liens, and treats the vendor as a secured claimant to the extent of the value of the goods in the vendor's possession.

States' laws differ on the extent and priority of the lien and whether it covers all amounts owed to the vendor or is limited to amounts directly related to the goods in its possession.

Vendors holding such potential possessory liens should not surrender possession to a debtor or trustee absent an adequate protection order, otherwise the vendor risks forfeiting its lien rights.

Disclosure

The Bankruptcy Code provides all creditors substantial rights to learn details about the debtor's financial condition, historical transactions and prospects for reorganization. Although creditors have the right to appear at and attend the Section 341 "first meeting of creditors," this is rarely productive. Modern practice has been that the Office of the United States Trustee conducts the 341 meeting and covers primarily administrative issues with limited opportunity for creditors to examine the debtor's representatives.

Rule 2004 of the Bankruptcy Rules permits creditors broad rights to examine the debtor under oath and penalty of perjury about its financial affairs, historical transactions and prospects for reorganization, and to obtain relevant documents.

These tools allow a creditor to obtain details about the debtor's financial condition necessary to evaluate the risk and probability of payment.

Involuntary Petition

Normally a bankruptcy proceeding is commenced by the filing of a voluntary petition for relief by the debtor. However, Section 303 of the Bankruptcy Code permits three or more creditors to file an involuntary petition against a debtor, in either Chapter 7 or Chapter 11, if certain requirements are met. The requirements are that the aggregate debt owed to the three or more creditors is at least $16,750 for 2021, such debts are not contingent as to liability or subject to a bona fide dispute, and the debtor is not generally paying its debts as they come due.

Unlike a voluntary petition where an order for relief is entered essentially simultaneously with the filing of the petition, in an involuntary case, upon the filing of the involuntary petition by creditors, a debtor has 30 days to file an answer to the petition. If the debtor contests the bankruptcy, the Bankruptcy Court will schedule and conduct a trial on whether the creditors' petition meets the requirements of Section 303 of the Bankruptcy Code.

During the "gap" period (time period between the date of the involuntary petition and the date a Bankruptcy Court enters an order for relief) note the following:

1. the automatic stay is in effect upon the filing of the involuntary petition;
2. claims arising during the "gap" period, including extensions of unsecured credit, are second-tier priority claims, which are subordinate to claims arising after the order for relief is entered; and
3. if an order for relief is entered, payments on pre-petition debts made during the "gap" period can be voided as avoidable post-petition transactions if no value was provided in the "gap" period.

Creditors may seek the immediate appointment of an interim trustee if there is a concern that the debtor may be dissipating assets.

Debtors have the absolute right to convert an involuntary Chapter 7 case to a Chapter 11 proceeding or vice versa.

A creditor considering an involuntary petition should always analyze payments received in the prior 90 days, as the involuntary filing will establish the 90 day preference period.

Motion to Convert to Chapter 7

A party in interest, which includes a creditor or creditors' committee, may file a motion seeking to convert a Chapter 11 case to a Chapter 7 liquidation case if the creditor can establish "cause" and show that a conversion is in the best interest of creditors. "Cause" includes:

1. Substantial losses and no reasonable likelihood of reorganization.
2. Gross mismanagement of the estate.
3. Failure to maintain insurance.
4. Unauthorized use of cash collateral.
5. Failure to pay taxes.
6. Failure to file or confirm a plan of reorganization within the applicable time period.

Assuming a creditor has the appropriate grounds for conversion, the creditor should nevertheless consider several issues.

Since a Chapter 7 trustee cannot operate the business, a conversion will likely result in a closure of the business operation and a quicker liquidation or auction of the assets, or an abandonment of the assets to the secured lender.

The Chapter 7 trustee will take control of the debtor and its assets, which cause creditors' committees or individual creditors to have less influence in the bankruptcy process. For example, a Chapter 7 trustee may have more incentive to aggressively pursue avoidance actions, such as preferences against creditors.

A conversion to Chapter 7 will end Chapter 11 administrative expenses; however, the Chapter 7 trustee and its counsel will incur administrative expenses that will have priority over the Chapter 11 administrative expenses. Moreover, the Bankruptcy Code allows the trustee to be paid a percentage of funds distributed to creditors.

Motion to Appoint a Trustee or Examiner

A party in interest including a creditor or creditors' committee can also file a motion seeking the appointment of a trustee or an examiner. A Chapter 11 trustee would supplant management and take control of the debtor's bankruptcy estate and assets. An examiner does not supplant management or take control of the debtor's estate; rather, an examiner investigates discrete issues, usually relating to questionable transactions, and reports findings to the Court and creditors.

A creditor may seek the appointment of a trustee or an examiner for cause including fraud, dishonesty, incompetence or gross mismanagement, if such appointment is in the best interest of creditors or if grounds to convert to Chapter 7 exists.

Claims Sale

There continues to be a vigorous market for the purchase of bankruptcy debt, particularly in larger bankruptcy cases. The purchasers are usually private equity or hedge funds that are in essence seeking to purchase claims at a discount in hopes that the ultimate dividend, whether in the form of cash payments or stock in the reorganized entity, will provide a return on such investment.

Claim purchasers will only purchase claims that are not disputed or contingent as to liability. Claim purchasers will usually agree to buy claims based on the debtor's schedules of assets and liabilities. However, purchasers will not buy claims based on a creditors' proof of claim if it is materially greater than the claim listed on the debtor's schedules, at least until the claim is resolved in the claims reconciliation process.

Creditors who sell claims should carefully review the claims assignment contract for pitfalls and potential risks.

EXECUTORY CONTRACTS

'Executory Contract' is the Bankruptcy Code term given to essentially any contract between a debtor and a non-debtor party where both parties owe performance to the other. A promissory note would NOT be an executory contract since the holder of the note has no performance obligations. However, a supply contract or other sales agreement would almost always meet the requirements of an executory contract under the Bankruptcy Code. Real estate or personal property leases are generally treated the same as executory contracts. The Bankruptcy Code Rules for rejecting executory contracts and leases are debtor-friendly, which is precisely why retailers who want to close stores often choose Chapter 11 as the vehicle to accomplish such goal.

The Bankruptcy Code provides debtors the right to elect to assume or reject executory contracts and unexpired leases. If a debtor rejects an executory contract, the non-debtor party receives a general unsecured claim for damages arising from the debtor's "breach" of contract. Thus, a debtor escapes the contract with little cost. On the other hand, the debtor also has the right to assume or assign a contract. In this instance, the Bankruptcy Code requires that the debtor "cure" the contract by paying existing defaults. Presumably, debtors would assume contracts that they deem to be valuable either because they ensure an uninterrupted supply of goods or contain favorable pricing or terms.

In many Section 363 sales, buyers elect to assume only absolutely essential contracts to avoid payment of the cure costs. Instead, buyers reject many contracts and attempt to negotiate with suppliers separately for revised contracts, and no cure payment.

For a creditor who is a party to an executory contract, the assumption of such contract can be an effective vehicle to obtain payment of pre-petition debt. Assumption of an executory contract also insulates the creditor from preference liability.

Debtors in Chapter 11 must assume an executory contract before or in conjunction with the confirmation of the Chapter 11 Plan. The non-debtor party to the contract can ask the court to set a shorter time if it will be harmed by the delay in the debtor's decision.

The Bankruptcy Code requires that the non-debtor party to an executory contract must continue to perform its obligations under the contract pending the debtor's decision to assume or reject such contract, and provided that the debtor is in fact performing its obligations of the contract post-petition.

Generally, the obligation to continue performance is subject to a seller's UCC Article 2 rights, including UCC 2-609 and UCC 2-702. However, Chapter 11 debtors often challenge this (usually at the behest of their financiers), and creditors will likely need to carefully review and object to first day motions to the extent that they seek to impair creditors' rights.

A supply agreement impacts a creditor's rights as a critical vendor since the leverage of not shipping is arguably eliminated in the context of an executory contract.

Some sales or distribution agreements include patent and/or trademark licenses. The Bankruptcy Code allows licensees of intellectual property to retain their rights for the duration of the license despite the debtor's rejection of the license agreement as long as the licensee continues to pay royalties. Trademarks are not included in the definition of "intellectual property" but some courts have nevertheless held that rejection of a trademark license does not terminate the licensee's rights.

PROOF OF CLAIM

A proof of claim is the document by which a creditor registers its claim with the debtor's bankruptcy estate, indicating the type of claim (secured, administrative, priority or unsecured), the amount of the claim and the basis for the claim.

Bankruptcy courts almost always set a bar date for filing proofs of claim several months after the bankruptcy petition is filed. To be considered, all claims must be filed on or before this bar date.

In a Chapter 11 case, if the debtor's Schedules of Assets and Liabilities list a particular creditor's claim correctly, and does not list it as unliquidated, contingent or disputed, and the creditor otherwise agrees with the debtor's Schedules, there is no need for the filing of a proof of claim.

In order to assure participation in any distribution to creditors or vote on a Chapter 11 plan, creditors often file a proof of claim, rather than rely on the debtor's Schedules of Assets and Liabilities.

The U.S. Supreme Court ruled in 2007 that unsecured creditors can include contingent claims for post-petition attorneys' fees based upon a pre-petition contract. A creditor whose claim arises under a pre-petition contract that expressly allows for attorneys' fees incurred in connection with the debtor's default should include a contingent claim for attorneys' fees in its proof of claim particularly in cases where post-petition litigation related to the claim is a possibility. Unsecured creditors are not entitled to post-petition interest on their claims.

Creditors who file a proof of claim waive the right to demand a jury trial in, for instance, a preference action.The potential costs and vagaries of a jury trial might provide leverage to a preference defendant.

SECTION 363 SALE

Section 363 of the Bankruptcy Code allows a debtor to sell substantially all of its assets free and clear of liens with liens attaching to proceeds of sale. This provision allows for the quick and efficient liquidation of a debtor's assets without having to first resolve the extent, validity and priority of liens on assets. This allows assets to be sold relatively quickly and avoids further erosion of value due to operating losses.

Buyers of assets often favor

acquiring assets in a Section 363 sale (thus requiring a Chapter 11 filing) since sales to good faith purchasers are not subject to later challenge.

Generally a Section 363 sale is teed up as an auction with a stalking horse sale as the initial bid. After appropriate advertising and marketing, an auction is conducted where interested buyers are permitted to overbid the stalking horse bid and thus allow the estate to obtain the greatest possible value for its assets. There is usually a required percentage bidding increment and the stalking horse bidder often has bid protection in the form of a break-up fee and expense reimbursement.

Secured creditors are generally entitled to "credit bid" their secured debt, provided the secured claim is not disputed.

Although a Section 363 sale can be a valuable tool for maximizing the liquidation value of a debtor's assets, such sales can also create an inherent tension between the secured creditor who asserts liens on the assets being sold and other creditors of the estate. The secured creditor's goal is payment of its secured debt and nothing more, while other creditors seek to achieve a sale in excess of secured debt to generate proceeds for other creditors. The quickest sale does not necessarily produce the best sale; however, prolonged sales processes have the disadvantage of higher administrative costs.

With increasing frequency, and due to the recent trend of high loan to value ratios, many Section 363 sales have produced sales proceeds less than the amount owed to secured creditors. These "short sales" create an administrative insolvency where only secured creditors benefit from the sale. Many courts have required the secured creditor to pay administrative claims associated with the Chapter 11 proceeding to obtain the benefit of the Chapter 11 process and protections. This has been euphemistically referred to as the "pay to play" rule. In addition, creditors often assert that the Chapter 11 process contemplates a benefit to all creditor classes and thus unsecured creditors should receive a "carve-out" of the sale proceeds to fund a dividend to unsecured creditors.

PLAN OF REORGANIZATION

A Plan of Reorganization is essentially the debtor's contract detailing how the debtor will satisfy pre-petition claims. This can be in the form of cash distributions, an allocation of future profits, and/or redistribution of the debtor's equity.

For a Plan of Reorganization (the "Plan") to become effective, it must be confirmed by the Bankruptcy Court. For purposes of Plan confirmation, similarly situated creditors are placed in classes of creditors, usually roughly corresponding to the claim priorities set forth above. If a class of creditors is unimpaired, meaning their claims are satisfied, that class is deemed to have accepted the Plan. For creditor classes that are impaired, the class must either consent to the Plan or be "crammed down." For a class to consent to a Plan, of the class members who vote, there must be more than 1/2 in number and 2/3 in dollar amount of creditors accepting the Plan.

A debtor can "cram down" its plan on non-consenting classes if the Plan is "fair and equitable," does not "discriminate unfairly" within classes, and is in the "best interests of creditors," primarily that the creditors will receive more in the Plan than in a Chapter 7 liquidation.

The so called "absolute priority rule" requires that a junior class of creditors cannot receive value on its claims unless senior classes are paid in full or vote to accept the Plan. Thus, unless unsecured creditors are paid in full, equity holders are not permitted to retain their equity interest absent a capital contribution commensurate to the value of the reorganized debtor's stock. To be confirmed, a Plan must also be feasible. A key element of feasibility is usually whether or not a debtor has committed exit financing. A credit crisis may undermine the ability of debtors to obtain exit financing, and thus exit Chapter 11.

AVOIDANCE ACTIONS

Preferences.

Bankruptcy Code Section 547 allows the debtor to recover pre-petition payments to third parties that were made within 90 days prior to filing as to non-insiders and within one (1) year prior to filing with respect to insiders. The requirements to assert a preference are that the payment in question be made within the appropriate time period, made while the debtor is insolvent, the payment was on account of antecedent debt and the payment allowed the creditor to receive more than it would have in a Chapter 7 liquidation. Debtors or trustees pursuing preference claims rarely have difficulty establishing these basic requirements.

The statute of limitations on preference actions is the later of (a) 2 years from the petition date or (b) 1 year from the date of appointment of the trustee.

Creditors who have received allegedly preferential payments have several statutory defenses, the most common three being: (1) the payment was made in the ordinary course of business; (2) the creditor provided subsequent new value after the payment at issue; or (3) the payment constituted a contemporaneous exchange for new value. The ordinary course of business defense is based on the notion that the payment in question was consistent with the ordinary course of business between the debtor and the particular creditor or consistent with industry standards generally.

In one case, the 10th Circuit Court of Appeals ruled that a first-time transaction can qualify for the ordinary course of business defense. A Delaware Bankruptcy Court has also ruled that a single transaction can qualify for the ordinary course of business defense. The Bankruptcy Court for the SDNY appears to require a "baseline of dealings" with the debtor, in which case single-transaction creditors must prove the payment was made according to "ordinary business terms."

Subsequent new value is simply that creditors provided additional value in the form of goods or services after receipt of the payment that in essence replenished the debtor's assets. The defense exists to the extent of such new value.

Contemporaneous exchange for value is where the parties intended the payment to be substantially contemporaneous with the creditor providing new value. The classic example of contemporaneous exchange for value is where a debtor desperate for goods promises to send a check if the creditor will release goods. Documentation of the parties' intent of payment in exchange for specific value is critical to this defense.

The Small Business Reorganization Act of 2019 (SBRA) contained amendments to preference laws, applicable to all Chapter 11 cases. In asserting preference claims, the Chapter 11 debtor now must exercise reasonable due diligence, taking a creditor's defenses into account. Also, for claims of $25,000 or less, the Chapter 11 debtor must assert the claims in the creditor's jurisdiction.

Fraudulent Transfers

Fraudulent transfers are a partial misnomer because actual fraud is not required. Under Section 548 of the Bankruptcy Code, a debtor can recover payments made to non-insiders for transfers occurring within one (1) year prior to bankruptcy and for two (2) years with respect to insiders if the transfers were made in an attempt to defraud creditors or if the transfer was simply for "less than reasonably equivalent value", assuming the debtor's insolvency.

The statute of limitations for asserting fraudulent transfer claims under is the later of (a) two (2) years from the petition date or (b) one (1) year after appointment of the trustee. Debtors and trustees in bankruptcy are also entitled to assert claims under state law fraudulent transfer statutes which are similar to the Bankruptcy Code's fraudulent transfer statute but often have a longer statute of limitations, and the reach back period may be longer.

Fraudulent transfer claims against vendors are not as common as preference claims. However, we have seen these claims asserted when the customer has numerous affiliates and a supplier invoices one entity, but payment to the supplier is made from a parent of the affiliate under a consolidated cash management system. Technically, the parent received no value for the payment to the supplier.

CROSS-BORDER INSOLVENCY

When a multi-national business faces insolvency, assets in more than one country likely require administration and protection. It is sometimes not clear what country's law will apply, and which jurisdiction will control the insolvency process. This issue can determine the outcome since countries' laws and approaches to business insolvencies can differ materially.

Typically, a multi-national business located outside the United States with assets in the United States would seek insolvency protection under the laws of its country, but will also file an "ancillary" proceeding in the United States.

There are many laws, treaties and regulations that address these issues, including:

Chapter 15 of the Bankruptcy Code on Ancillary Cases

1. Mostly follows the United Nations' Model Law on Cross-Border Insolvency
2. Chapter 15 passed as part of the 2005 Bankruptcy Code Amendments

- UNCITRAL (United Nations Commission on International Trade Law) Model Law on Cross-Border Insolvency has, as its goal, to "modernize and harmonize the rules on international business and to enhance predictability in cross-border commercial transactions".
- The European Union Regulation on Insolvency Proceedings
- The ALI NAFTA Transnational Insolvency Project
- COMI (or Center of Main Interests) is a key concept in Chapter 15, the UNCITRAL Model Law and the

European Union Insolvency Regulation, all of which presume COMI is where an entity has its corporate registration.

- COMI impacts where the main proceeding should occur, based on where a business has its "center of main interests", which is analogous to the principal place of business. Thus, if COMI exists in a foreign country, a U.S. Bankruptcy judge should recognize a foreign insolvency proceeding as the "foreign main" proceeding and the U.S. Chapter 15 proceeding as an "ancillary" proceeding. If a debtor does not have COMI in the country where it files its insolvency proceeding, but has an "establishment" in such country, the U.S. Bankruptcy Court should recognize the foreign proceeding as a "foreign non-main" proceeding.
- If the foreign insolvency proceeding is recognized as a "foreign main" proceeding, the approval of the Chapter 15 proceeding will invoke the automatic stay. If the foreign insolvency proceeding is recognized as a "foreign non-main" proceeding, the Chapter 15 proceeding will not invoke the automatic stay protections.

Preferences in Chapter 15. Chapter 15 provides that Sections 547 (preferences) and 548 (fraudulent conveyances) are not available as remedies to foreign representatives in a Chapter 15 case. However, in 5th Circuit U.S. Court of Appeals case (Condor Insurance Ltd.), the Court ruled a foreign representative could pursue "avoidance" remedies using the avoidance laws of the foreign jurisdiction. ■

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