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PRESENTATION OF DAVID M. GROGAN ON HOT TOPICS IN BANKRUPTCY AND CREDITORS' RIGHTS TO CHARLOTTE CFDD ON APRIL 17, 2014

OVERVIEW

- Do reclamation claims have any value?
- What are section 503(b)(9) claims? When are goods "received by the debtor"? Can the same shipment of goods be paid as a section 503(b)(9) claim ***and*** count for subsequent new value credit to a preference claim?
- What are the dangers of postpetition sales? COD? Trade credit? How can the debtor's unauthorized use of cash collateral result in the recovery of postpetition payments?
- What are the dangers of a prepetition setoff of claims? How do you value the claims being offset? Can you offset postpetition? How is setoff different from recoupment?
- Why has there been such a reduction in the filing of chapter 11 bankruptcy cases?
- Why are so many chapter 11 bankruptcy cases being resolved primarily through a section 363 sale of assets rather than through confirmation of a plan of reorganization?
- How can a creditor's lien rights be inadvertently lost in a bankruptcy case?
- Why is my judgment against a contract-breaching Chinese supplier worthless?
- Why should my attorney ***not*** sign my proof of claim?
- Why is Mt. Gox's chapter 15 filing so ironic? What is chapter 15 anyway? How did the IRS and United States Treasury recently pile-on to Bitcoin holders' misery?

These materials are intended as a brief overview of bankruptcy law concerning the topics addressed and not as specific legal advice. A complete analysis of these topics is beyond the scope of these materials. If you would like to discuss the issues and techniques concerning any of these topics, please do not hesitate to contact David Grogan in the Bankruptcy and Creditors' Rights Group of Shumaker, Loop & Kendrick, LLP, at dgrogan@slk-law.com or 704-945-2143.

RECLAMATION CLAIMS

The Uniform Commercial Code continues the common-law right of a seller to reclaim goods from an insolvent buyer that has not paid for the goods. The Bankruptcy Code provisions regarding reclamation of goods were amended in 2005 and have the following requirements for a reclamation claim:

- The goods must have been sold in the ordinary course of the seller's business.
- The debtor must have been insolvent when the goods were received.
- The debtor must have received the goods within 45 days before the bankruptcy was filed.
- A written demand for reclamation must be made on the debtor within 20 days after the bankruptcy was filed, if the 45-day period expires after the filing.
- At the time of the demand, the goods are still in the debtor's possession, are identifiable (not commingled), and have not been converted into a finished product.
- The goods to be reclaimed are not subject to the prior rights of a secured creditor.

The reclaiming creditor has the burden of proof on all of these elements of a claim. The last two requirements, either separately or in combination, are usually fatal to a reclamation demand. Bankruptcy debtors are often operating hand to mouth prior to filing bankruptcy; therefore, goods delivered 45 days before the filing, and often goods delivered just a few days before the filing, either have been sold to the debtor's customers and are no longer in the debtor's possession or have been changed in form or incorporated into the debtor's finished products so that the delivered goods are no longer subject to reclamation. Commodity-type goods and goods without identifying marks of the vendor may be commingled with similar goods from other vendors and thereby are no longer subject to reclamation.

A lender's floating lien on the debtor's inventory will trump reclamation rights. Courts have held that a vendor cannot require the lender to first look to collateral other than the inventory, so if the debt to the lender exceeds the value of the inventory, no reclamation claim will be allowed.

Because of the last two requirements, reclamation claims have a limited chance of actually obtaining payment. However, it costs virtually nothing to make a reclamation demand, as "the writing" can be delivered to the debtor by mail, overnight courier, or even email. So a creditor might as well make the reclamation demand and see if something can be obtained.

SECTION 503(b)(9) CLAIMS

As part of the 2005 amendments to the Bankruptcy Code, the NACM obtained the insertion of a new provision, section 503(b)(9). This section allows administrative expense priority for goods sold to the debtor in the ordinary course of the debtor's business and received by the debtor within 20 days preceding the bankruptcy filing.

These "503(b)(9) claims" are much more valuable than a reclamation claim as they are not subject to existing security interests or liens and do not require the claimant to prove insolvency. The claimant will have an allowed administrative expense that is typically paid at confirmation of a chapter 11 plan. The Bankruptcy Code requires that administrative claims be paid in full at confirmation, unless the claim holder agrees to other treatment in the plan, so this claim fairly well ensures that the claim holder will be paid in full, unless the case is administratively insolvent, in which case the claim should be paid pro rata with other administrative expenses, such as the debtor's and committee's professionals' fees.

There are four elements to a 503(b)(9) claim. The first is that the claim arises from sales made in the ordinary course of the debtor's business. The ordinary course element is virtually always met—the creditor was selling goods that the debtor typically buys in operating the debtor's business. The second element is that creditor must have provided goods, not services. If what a creditor provided was part goods and part services, some courts apportion the amount of the claim between the two classifications, and some courts determine which predominates and allow all or nothing for the claim. There is some question about how tangible the product has to be to be considered a good: For example, a natural gas utility is entitled to 503(b)(9) priority, as it is providing molecules of methane, but courts disagree on whether an electric utility is providing goods (namely electrons, which is a stretch) or a service (electrical energy).

The third element is that the goods be received by the debtor. Several courts have held that drop shipments to the debtor's customer or processor are ***not*** entitled to this priority, as they were not received by the debtor—a harsh rule. The fourth element is that the goods be received by the debtor within 20 days preceding the bankruptcy filing. The use of "received" has been interpreted to mean finally and irretrievably received. Goods may be shipped by common carrier "FOB Seller;" however, if the seller contracted with the common carrier and still has the right of stoppage in transit, the goods are not "received by the debtor" until they are unloaded by the carrier at the debtor's facility.

Courts have ruled both ways on whether shipments that the creditor seeks to have paid as administrative expenses as a 503(b)(9) claim can also count as part of a subsequent new value defense to a preference claim. A December 2013 ruling by the Third Circuit Court of Appeals (affirming a decision by a Delaware bankruptcy judge) held that the bankruptcy filing date is a bright line that fixes the preference liability as of that date, so the payment of the 503(b)(9) claim after the filing does not change the preference analysis, and the creditor can also count these shipments as subsequent new value. This can make a huge difference in preference liability.

The Bankruptcy Code does not state how a 503(b)(9) claim should be made. Some bankruptcy courts create a special form that looks similar to a proof of claim form and allow such forms to be filed by the creditor. In other courts, a 503(b)(9) administrative expense claim must be filed like any other administrative expense claim, which is by an application filed with the court, with the claim being allowed by order. If the creditor is a corporation, the application can be filed only through an attorney.

POSTPETITION SALES TO A DEBTOR

Chapter 11 debtors frequently push their vendors to provide postpetition trade credit. In general, a creditor has no obligation to provide postpetition trade credit and can legally insist on cash before delivery or cash on delivery. However, there is the risk that the debtor may find an alternate vendor who will provide credit terms. Providing postpetition trade credit to some extent may be a necessary risk in order to keep the debtor as a customer during the reorganization period and hopefully continuing after confirmation of a plan.

Where there is a prepetition contract for the sale and purchase of goods on credit, the debtor may argue that the vendor is obligated by this executory contract to continue to sell postpetition on the same credit terms until such time as the debtor either assumes or rejects the contract. Generally, the best response of the vendor is to state that it deems itself insecure, which excuses further performance (credit sales) until the vendor is provided with adequate assurance of future performance by the debtor (such as agreeing to pay COD). The vendor may be well advised to follow this response with a motion to the court to compel the debtor to promptly decide whether it wishes to assume or reject the contract. If the debtor can be pressed into assuming the contract, then it will have to promptly cure all prepetition and postpetition defaults.

Unsecured postpetition credit incurred by a debtor in the ordinary course of operating its business can be paid by the debtor as an administrative expense without specific authorization by the bankruptcy court. The main risk of providing such credit is that the debtor may become administratively insolvent and not be able to pay its postpetition unsecured claims. In this situation, any secured lender would be paid first from the remaining assets, and the unpaid postpetition unsecured claims would be paid pro rata. The vendors that had extended postpetition credit and been paid by the debtor would not have to return their payments and then share pro rata, but those that had not been paid would have to share and be at risk for not being paid in full. There is some authority for the proposition that postpetition trade creditors should be paid in full before postpetition professionals are paid, but that is by no means a general rule.

A rarely encountered but serious risk is that postpetition vendors may have been paid but nonetheless have to return their payments. A prepetition lender to the debtor typically has a security interest in the debtor's "cash collateral," which is generally composed of the debtor's cash and the proceeds of the debtor's accounts receivable and inventory. Although in a chapter 11 case the court will immediately enter an order allowing the debtor to operate its business, the debtor can spend a lender's cash collateral only if the lender consents or the court, following a hearing on the use of cash collateral, finds that the lender's interest is adequately protected and orders that the debtor may use the cash collateral.

In a case from a few years ago, the lender did not consent to the use of its cash collateral, and the hearing on the debtor's motion to use the cash collateral was continued for several weeks. In the meantime, the debtor, a gas station/convenience store, continued to purchase gasoline and other products and pay the vendors. The bankruptcy court ultimately held that the lender was not adequately protected in the use of its cash collateral, and the use was denied. The vendors that had in good faith sold products to the debtor and been paid for them had to return all of the payments they had received over several weeks. This circumstance should be extremely rare, but the consequences are horrific. A "check the box" caution for any creditor selling to a debtor postpetition, whether on credit or on COD terms, is to verify that there is an order authorizing the postpetition use of the lender's cash collateral and the order remains in effect.

SETOFFS

A consideration related to preferences is setoff. The Bankruptcy Code allows a debtor or trustee to recover from the creditor if there is a setoff of mutual debts between the debtor and creditor within 90 days before the bankruptcy filing, if the "insufficiency," which is the excess of the amount owed by the debtor over the amount owed by the creditor, was less at the time of the setoff than it was at the start of the 90-day period. The amount recoverable is the improvement in the insufficiency between those times, and the recovery is roughly analogous to a preference recovery.

If a creditor and debtor are buying and selling different products and services to each other and have credit balances with each other, and for some period of time the debtor sells more to the creditor than the debtor buys, the insufficiency is reduced and the creditor has had a favorable improvement of position. In such a situation, ***do not*** casually offset some amount for these mutual debts, as that may trigger the liability under the setoff section of the Bankruptcy Code.

This section of the Bankruptcy Code preserves the ***right*** of setoff. Therefore, if a creditor owes and is owed mutual debts by a customer that is at risk of filing bankruptcy, he should not offset those debts, but simply let them run. There is no avoidance recovery against the creditor so long as the creditor does not offset, but there can be a recovery if he does so. This anomaly in the Bankruptcy Code originated with the enactment of the Code in 1978 and has yet to be corrected. Note that the shipments by the debtor would not be recoverable as a preference, as they are merely sales by the debtor to the creditor and are not transfers on account of an antecedent debt, which is a necessary element of a preference. Conceivably, a creditor who realizes his customer is headed toward bankruptcy and the creditor wants to reduce his exposure, rather than being paid down by the customer and being exposed to a preference risk, he could order more from the customer and stockpile it while at the same time reducing the net owing by the customer. But don't offset the debts!

If doing a setoff, a creditor should not casually agree to the customer's valuation of the obligations being offset, thinking that the creditor can never collect the full net obligation anyway. The creditor should carefully document the calculation of the claims being offset, and if there is a "gimme" aspect to the customer that is really a debt forgiveness, that should be expressly shown as such. Otherwise the creditor might find, if bankruptcy is filed within 90 days, that two years later he has to return the "gimme" in cash to the estate as an improvement in the insufficiency.

After the bankruptcy filing, the creditor can at some point ask the court to authorize the offset of the claims, and such motions are generally routinely granted.

Recoupment is not subject to recovery as is setoff, and it is not subject to the limitation of the automatic stay and so can be done postpetition without court authorization. However, recoupment must arise out of a single integrated transaction. When the contract contemplates business to be transacted as discrete and individual units (such as purchase orders and invoices), then claims between the two parties are not eligible for recoupment, and any setoff may be subject to later recovery in a bankruptcy case.

THE REDUCTION IN CHAPTER 11 FILINGS AND THE RISE OF 363 SALE CASES

House prices began falling in the summer of 2006, and commercial lending had a seizure in August 2007, but the Great Recession began in earnest in 2008 with the collapse of Bear Stearns and then Lehman Brothers. There was a spike in chapter 11 filings in the next few years, but chapter 11 work has been noticeably slow since the middle of 2010. It is largely a mystery as to why this slowdown has occurred, and no one cause appears to be responsible, but the following appear to be contributors:

- In 1999, the Supreme Court issued the *LaSalle* decision, finding that in order for a company to reorganize and allow the existing owners to stay in control by buying back their equity, the value of the equity had to be tested by the market. This was new in chapter 11 cases. Previously, owners had to put in some new cash in order to meet the absolute priority rule and thereby keep their equity, but they would typically have some expert testify that the price being paid was fair as the business was distressed and of low value. The Supreme Court required that the debtor hold an auction for the equity or allow other parties to file a competing plan, which meant that the owners' equity was "in play." Owners became reluctant to risk losing control of a chapter 11 case that they had commenced.
- With declining values of real and personal assets that were collateral for lenders' loans, many lenders chose to "extend, amend, and pretend" by granting extensions and forbearances. A lender might not want to take the loss on a loan through forcing a foreclosure and trying to liquidate the assets in a sharply down market, or by selling its loan at a steep discount, but instead wait and hope that over time either the lender's, or its borrower's, financial condition will improve.
- With the changes to Article 9 of the Uniform Commercial Code in 1999, it became easier for secured creditors to tie up all of the debtor's assets with an "all-asset" UCC-1 filing. It is the rare chapter 11 case where the debtor does not need to obtain debtor in possession ("DIP") funding, and in times past, when financing statements had to describe the secured assets by category and sometimes by serial number, the debtor or the creditors' committee could play "gotcha" by finding some asset or class of assets on which the secured creditor had failed to perfect its security interest. This current absence of unencumbered assets means that a DIP lender cannot be giving a security interest in assets not already encumbered. The declining values of real and personal assets that were collateral for the secured creditor's loans means that there is a lesser, or no, equity cushion that can allow a DIP lender to take a priming lien. The existing secured lender much more frequently has a virtual veto over any chapter 11 plan.
- There has in general been an erosion of long-term relationships between vendors and customers and between banks and customers. Exacerbating this has been the great increase in the trading of bankruptcy claims, which has been fueled by the purchase of unsecured and secured debt at steep discounts by venture capital and hedge fund investors. Whereas trade creditors may have an interest in seeing the debtor be reorganized and continue purchasing in the future, these new investors have extremely short time horizons and want a quick profit and exit.

- Section 363 sales, which are sales free and clear of liens and encumbrances, have become the favored vehicle for the claims holders to quickly realize a distribution on their claims, and for entities to acquire the debtor's assets and business without legacy costs. 363 sales can be accomplished in only a couple months, provide the purchaser with assets free and clear of claims and liens of any kind, and offer injunctive protection against claims, and the sale process and sale are virtually final and impervious to any appeal.
- The Supreme Court recently settled the issue that secured creditors can credit bid at 363 sales, so an entity interested in purchasing a troubled company for strategic reasons may buy the secured debt at a discount, put the company in bankruptcy, and then credit bid its secured claim in a 363 sale at or up to the full amount of the claim.

INADVERTENT LOSS OF LIEN RIGHTS

American common law follows British common law prior to the Revolutionary War that grants a possessory lien to a creditor that has made improvements to a debtor's property. The lien is for improvements on only the property that is in the creditor's possession, is perfected without filing any document, and is lost by surrendering possession. Some states have codified possessory liens into statutory law, and some have expanded on them, such as North and South Carolina that grant a possessory lien to textile processors on goods in their possession for processing done on other goods that have been returned to that same owner.

A possessory lienholder may be subject to demand by the debtor or the trustee under section 542 of the Bankruptcy Code to turn over the property. Simply complying with the demand waives the possessory lien, but noncompliance could subject the lienholder to penalties for violation of the automatic stay. The lienholder should instead immediately file a motion for adequate protection of the lien, so that it can get an order protecting the lien even though the property is then turned over to the estate.

A bankruptcy maxim is that liens can ride through unaffected. Relying on this has become as risky as relying on "possession is nine-tenths of the law." The other one-tenth can get you. The Bankruptcy Code provides that property dealt with in a confirmed plan is free and clear of liens except to the extent preserved in the plan. The Bankruptcy Rules provide that a challenge to the validity, priority, or extent of a lien can be resolved only through an adversary proceeding commenced with a complaint and served on the lienholder along with a summons. The Fifth Circuit Court of Appeals (Louisiana, Mississippi, and Texas) has held that mere notice to the creditor of a chapter 11 plan is not enough to void the creditor's lien in the plan; the lender must have actively participated in the case to lose its lien. However, the Fourth Circuit (North and South Carolina, Maryland, Virginia, and West Virginia) has held that a lien can be lost through a plan or a mere motion if the creditor receives notice and does not object to the procedural defect of the plan proponent or movant not following the Rule and filing and serving a complaint and summons.

WHY IS MY JUDGMENT AGAINST MY CHINESE SUPPLIER WORTHLESS?

Your Chinese supplier seriously defaults on your supply contract and causes substantial damages to your business. Fortunately(?), your contract provides that United States courts have exclusive jurisdiction over disputes (who wants to have to litigate in China?), and you now have a default judgment against the supplier for $300,000 issued by the United States District Court for the Western District of North Carolina.

Now what? Transcribe the judgment to a court in China and begin to execute on the supplier's assets there? Nope. China has not ratified any treaty with the United States requiring it to honor American judgments, and China does not particularly like the American legal system. So, Chinese courts would likely ignore any attempt to enforce the judgment in China.

Start over with a new lawsuit in China? Nope. The written contract states that all enforcement disputes must be brought in a particular United States court. A Chinese court will likely not enforce an American judgment, but it will likely enforce this contract provision. Further, you already have an American judgment, so the principle of collateral estoppel will block a new lawsuit in China. Chinese courts will enforce this contract provision, and particularly so when it favors a Chinese defendant.

How do you avoid ending up with a zombie judgment? Have the contract provide for resolution of disputes in Chinese courts applying Chinese law. An arbitration clause may work, as sometimes Chinese courts will enforce a foreign arbitration. Or, if stuck with a judgment from an American court, you might be able to locate other American customers of this Chinese vendor and garnish their accounts payable to the Chinese company. This is by no means sure fire, as the payment procedure of that customer to the supplier may involve a factor or other third party that can insulate the receivables from garnishment.

WHY SHOULD MY ATTORNEY NOT SIGN MY PROOF OF CLAIM?

All bankruptcy courts want proofs of claim and everything else filed electronically. Non-attorneys can file a proof of claim, but one might think that it is more convenient to have the attorney navigate the court's website to file a proof of claim than do it himself. What can go wrong?

The official proof of claim form provides just above the signature line, "I declare under penalty of perjury that the information provided in this claim is true and correct to the best of my knowledge, information, and reasonable belief." In a recent case, there was a hot dispute over the validity of a claim and the motives of the creditor asserting the claim. The court held that the attorney's signing of the proof of claim was an assertion of personal knowledge of the facts alleged in the proof of claim, which made the attorney a fact witness as to the allegations in the proof of claim and waived the attorney-client privilege and the work-product privilege.

In most garden-variety cases where there is no animosity between the parties, a proof of claim may be subject to dispute over quality of the goods or other issues, but the signing of the proof of claim by the attorney will not lead to a finding of waiver of the privileges. However, this risk can be avoided by the attorney having the client physically sign the proof of claim and send a pdf copy to the attorney for filing, so it is the client's signature on the form and the client's attestation as to the correctness of the information.

WHY IS MT. GOX'S CHAPTER 15 FILING SO IRONIC?

Bitcoin is a "currency" that has become popular among techies, conspiracy theorists, fiat-currency gloom and doomers, drug dealers, and others. Bitcoin exchanges are not banks, so the users of Bitcoin have believed that the exchanges do not have the same reporting requirements as banks for shady transactions that may include the laundering of drug money, such as the recent criminal bust of the principals of the Silk Road black market exchange based on Bitcoins. Recently, a Japanese Bitcoin exchange, Mt. Cox, filed insolvency proceedings in Japan when it reported about 850,000 Bitcoins owned by the exchange's customers and valued then at about $450 million went missing. The Mt. Gox story is that the Bitcoins were stolen by hackers, but then Mt. Gox "found" about 200,000 of them in one of its wallets. Mt. Gox filed a chapter 15 ancillary bankruptcy proceeding in the United States in support of the Japanese insolvency proceeding.

Bitcoin is somewhat like as a currency, but it is quite different. There are two types of currency: fiat and commodity-based. The commodity-based is a gold or silver standard; fiat relies on a government. Fiat currency of the United States has not been backed by anything other than the full faith and credit of the government since 1971. Bitcoin is a type of fiat currency that is not backed by any central institution nor backed by any commodity. It is backed only by the Bitcoin network and by people using Bitcoin because of the perceived efficiency in transactions.

The Mt. Gox chapter 15 filing in the United States is ironic for several reasons:

- The conspiracy theorists want a monetary medium of exchange that is not overseen by a government. (For a great novel on conspiracy theorists wanting a separate postal system, read Thomas Pynchon's *The Crying of Lot 49*.) They got what they asked for—Bitcoins that are lost or are stolen by a hacker are gone forever as the transactions are irreversible. Good luck to the Mt. Gox customers in getting their Bitcoins back with the help of American courts in the chapter 15 proceeding.
- The fiat-currency gloom and doomers think that at any moment the government fiat currencies could collapse, and, as during the Weimar Republic in Germany in the early 1930s, we would need a wheelbarrow-full of paper currency to buy a loaf of bread. The customers of the Mt. Gox exchange had their electronic wallets picked for hundreds of thousands of Bitcoins, and the value of Bitcoins has dropped from a peak of about $1,150 in December 2013 to about $450 in April 2014. Fiat currency in a bank insured by the FDIC looks quite safe by comparison. Warren Buffet has commented that Bitcoin is a "mirage."
- The drug dealers want the anonymity of a Bitcoin exchange rather than using a bank. Yet every Bitcoin transaction is recorded and available for government review through a subpoena. A drug dealer caught in a cash transaction may be criminally liable for that one transaction, but one caught in a Bitcoin transaction may find that the prosecutor has a full record of his other drug transactions.

The United States Treasury and the IRS have piled on to the misery of Bitcoin investors. Foreign currency gains and losses generally are taxed as ordinary income, and losses may be deducted from income up to the full amount of one's income and then carried over to other years. However, the IRS has held that Bitcoin is not a currency, as it is not issued by a government, but is instead property. Therefore, gains and losses on Bitcoin transactions are not ordinary income

but capital gains and losses. Capital losses can be offset against capital gains, but beyond that can be deducted only up to $3,000 per year. So the Bitcoin investors who may have lost hundreds of thousands of dollars or more with Mt. Gox or other Bitcoin exchanges will be able to deduct only $3,000 of that loss in each tax year unless they have capital gains to use for offset.

Conversely, the U.S. Treasury Financial Crimes Enforcement Network says that although Bitcoin is not legal tender, Bitcoin exchangers are money transmitters and thus subject to the Bank Secrecy Act, which was first passed in 1970 before the internet existed. Bitcoin exchanges must comply with the money service regulations, even though the IRS doesn't recognize Bitcoin as a currency, and the burden of complying with these regulations is contributing to the closing of several Bitcoin exchanges.

What is chapter 15 of the Bankruptcy Code? The purpose of chapter 15 is to incorporate the Model Law on Cross-Border Insolvency, which was promulgated by the United Nations Commission on International Trade Law in 1997. Chapter 15 was created by the amendments to the Bankruptcy Code adopted in 2005. Chapter 15 allows the representative of a bankruptcy proceeding in a foreign country to commence a bankruptcy case in the United States to aid the adjudication of the foreign proceeding.

Objectives of the chapter are:

- cooperation between courts (comity),
- greater legal certainty for trade and investment,
- fair and efficient administration of cross-border insolvencies,
- protection and maximization of the value of the debtor's assets, and
- facilitation of the rescue of financially troubled businesses.

A more colloquial statement of the purpose of chapter 15 is to prevent foreign debtors from "squirreling away assets in the United States outside of the reach of the foreign jurisdiction."