Bankruptcy in the US: The Need to Know Bankruptcy Concepts Part 2

David Conaway continues his executive summary of the "need to know" bankruptcy concepts as they impact creditors in business insolvencies in the US, starting with further options for remedies for creditors

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Creditor Remedies

Motion to Convert to Chapter 7

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

- Substantial losses and no reasonable likelihood of reorganisation
- Gross mismanagement of the estate
- Failure to maintain insurance or pay taxes

A Chapter 7 trustee cannot operate the business, thus a conversion will likely result in a closure of the business and a quicker liquidation 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. A Chapter 7 trustee may have more incentive to pursue avoidance actions such as preferences against creditors.

The administrative expenses of the Chapter 7 trustee and its counsel will have priority over the Chapter 11 administrative expenses. Moreover, the Bankruptcy Code allows the trustee to be paid as high as 3% of the funds distributed to creditors.

Motion to appoint a trustee or examiner

A creditor or a creditors' committee can also file a motion seeking the appointment of a trustee or an examiner. A Chapter 11 trustee supplants management and assumes 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 or 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.

Claims Sale

At least up until the recent economic crisis, there has been a vigorous market for the purchase of bankruptcy debt, particularly in larger bankruptcy cases. The purchasers are usually Wall Street funds seeking to purchase claims at a discount, hoping for 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, not on a creditors' proof of claim if it is materially greater than the claim listed on the debtor's schedules.

Executory contracts

Executory Contract is a bankruptcy concept for contracts between a debtor and a non-debtor party where both parties owe performance to the other. A supply contract or other sales agreement would almost always be an executory contract. Real estate leases are also treated as executory contracts. The Bankruptcy Code provisions for rejecting executory contracts and leases are debtor-friendly which is precisely why retailers who want to close stores often choose Chapter 11.

The US Bankruptcy Code provides debtors the right to assume or reject executory contracts and 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. 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.

The Bankruptcy Code requires the non-debtor party to perform its obligations under the contract pending the debtor's decision to assume or reject such contract, provided the debtor performs its post-petition obligations.

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, amount and basis for the claim.

All claims must be filed within the bar date set by the Bankruptcy Court.

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 favour

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.

A Section 363 sales can 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 only its secured debt, while other creditors seek to achieve a sale in excess of secured debt to generate proceeds for other creditors.

With increasing frequency, Section 363 sales have produced 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 "pay to play" rule can also include a "carve-out" for unsecured creditors.

In the recent *Clear Channel* case, the Ninth Circuit (includes California) Bankruptcy Appellate Panel (BAP) ruled that in the case of a "short sale", the Section 363 sale was **not** "free and clear", and the buyer acquired the assets **subject to** the junior liens. Whether *Clear Channel* is an aberration remains to be seen.

Plan of reorganisation

A Plan of Reorganisation is the debtor's contract detailing how the debtor will satisfy pre-petition claims, in the form of cash, future profits, or the debtor's equity.

If a class of creditors is unimpaired or satisfied, that class is deemed to have accepted the Plan. For impaired creditor classes, the class must either consent to the Plan or be "crammed down". Consent requires of the class members who vote, more than half in number and two thirds in dollar amount accept 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 creditors will receive more in the Plan than in a Chapter 7 liquidation.

To be confirmed, a Plan must also be feasible, including committed exit financing. The current 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 made within 90 days prior to filing as to non-insiders and within one year prior to filing with respect to insiders. The payment in question must also be made while the debtor is insolvent, on account of antecedent debt and the payment allows the creditor to receive more than it would in a Chapter 7 liquidation.

The statute of limitations on preference actions is two years from the petition date.

Creditors have several substantial defenses, including that the payment was made in the ordinary course of business, that the creditor provided subsequent new value after the payment at issue, or that the payment constituted a contemporaneous exchange for value.

Fraudulent Transfers

The debtor can recover transfers to non-insiders within one year prior to bankruptcy and two years for insiders, that were made to defraud creditors or when the transfer was for "less than reasonably equivalent value". A statute of limitations on fraudulent transfer claims is two years from the petition date.

Cross-border insolvency

Typically, a global business 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, which mostly follows the United Nations' Model Law on Cross-Border Insolvency.

A key difference between the US Bankruptcy Code and most foreign bankruptcy laws is the concept of "Debtor in Possession". In US bankruptcy cases, it is extraordinary for a trustee or examiner to be imposed, while most foreign insolvency laws require the appointment of a third party administrator or liquidator with varying degrees of responsibility and involvement regarding the business.

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