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

David Conaway gives us a summary of the "need to know" bankruptcy concepts as they impact creditors in business insolvencies in the US

Chapter 11 vs. Chapter 7

Chapter 11 is technically used for bankruptcy reorganisations, while Chapter 7 applies to liquidations. Chapter 11 has been increasingly used as a tool to liquidate business assets as a "going concern", hence the frequent "liquidating 11". By contrast, in a Chapter 7 liquidation, the appointed trustee is not permitted to operate the business, except in rare circumstances. Accordingly, any going concern value can be achieved only through a "liquidating" Chapter 11.

The US Bankruptcy Code has unique provisions allowing debtors to sell assets free and clear of liens (with liens attaching to proceeds), which enable a debtor to deliver "clear" title to prospective buyers.

Automatic stay

To promote the bankruptcy concept of providing "breathing room" to debtors, the US Bankruptcy Code enjoins any action to collect pre-petition debts owed to creditors. This would include commencing or continuing a lawsuit, entering or enforcing a judgment, terminating contracts or taking any other action to enforce payment. There are limited occasions where the Bankruptcy Code permits a creditor to obtain "relief from stay" to proceed.

First day motions

Debtors usually file "first day" motions which are scheduled for hearing a day or two after the bankruptcy filing. Most of the "first day" motions are procedural and administrative, but there are also substantive motions, such as the debtor's motion to approve debtor in possession or "DIP" financing.

The Bankruptcy Code provides that pre-petition liens on collateral do not extend to property acquired by the debtor post-petition. In addition, the Bankruptcy Code provides that the debtor may not use as working capital the lender's "cash collateral", which is the cash generated by inventory sales and accounts receivable collections, unless the lender consents or the Bankruptcy Court permits the debtor to use cash collateral over the lender's objection.

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Bankruptcy Courts almost always approve DIP financing as necessary to allow a debtor to continue operating, although creditor objections can modify or eliminate objectionable provisions of the DIP financing. As an alternative source of cash, Debtors unable to obtain DIP financing may seek Bankruptcy Court permission to use the lender's "cash collateral" over the lender's objections.

Doing business with a Chapter 11 debtor

Upon the filing of a Chapter 11 by a customer, vendors must determine whether to sell to the debtor post-petition. To avoid the inherent risk of a Chapter 11, vendors often sell on a cash before delivery or "CBD" basis. The Bankruptcy Code treats credit extended to a Chapter 11 debtor in the ordinary course of business as an administrative expense priority claim, which are generally paid in full, absent an "administrative insolvency".

Where vendors have open purchase orders from debtors that arose prior to the Chapter 11 filing, that provide for post-petition shipment by the vendor, a practical solution is to require the purchase orders to be re-issued post-petition. Many debtors, particularly in larger cases, file a "first day" motion seeking an order from the Bankruptcy Court granting administrative claim priority for post-petition shipments on pre-petition orders, to avoid the re-issuance of purchase orders.

Schedules of assets and liabilities and statement of financial affairs

The Bankruptcy Code imposes a requirement on every debtor to file detailed Schedules of Assets and Liabilities as well as a Statement of Financial Affairs. The Schedules of Assets and Liabilities list the debtor's assets and values and detail the names of secured and unsecured creditors, the amount of the indebtedness and whether or not the indebtedness is disputed. The Schedules also contain a list of equity holders, contracts to which the debtor is a party, and transfers made to insiders and non-insiders prior to the bankruptcy filing.

Claim priorities

The Bankruptcy Code sets forth clear priorities of payment or entitlement to payment by types of creditors or claims as follows.

- Secured creditors
- Administrative claims
- "Gap" period claims
- Limited employee wage claims
- Certain employee benefit contribution claims
- Limited consumer deposit claims for the purchase of goods or services
- Certain government tax claims
- General unsecured claims
- Equity interests

> **"An often overlooked remedy, set-off arises from the settlement of mutual debts or accounts owed between a debtor and a creditor"**

Secured, administrative and priority claims are generally paid in full while unsecured claims are rarely paid in full. Equity interests are almost always canceled at no value.

There are many exceptions to the general rules, particularly in the case of an "administrative insolvency", where the value of the debtor's assets are insufficient to pay the lender's claims and also the administrative claims, much less claims "below the line".

Creditor remedies

20-Day administrative claim

Section 503(b)(9) to the Bankruptcy Code provides that sellers of goods are entitled to an administrative priority claim for the value of goods delivered to a debtor within 20 days prior to the bankruptcy filing. Upon a motion by the creditor, most courts have allowed vendors an administrative claim for the value of goods delivered within 20 days prior to the filing. Courts have been less willing to order immediate payment of 20 day administrative claims, instead allowing them to be paid in connection with plan confirmation or in connection with the sale of substantially all of the debtor's assets.

Reclamation

Reclamation is based upon a state law remedy arising from the Uniform Commercial Code's provisions on sales of goods, which allows a vendor to reclaim goods delivered to a customer (or stop goods in transit), if the seller learns of the customer's insolvency.

Critical vendor

Critical vendor is a creditor remedy based on a theory that a particular vendor is so essential to a debtor's ability to continue operating that without the uninterrupted flow of the seller's goods, the debtor cannot continue to operate and thus has no realistic chance of a successful reorganisation. In these instances, a bankruptcy court has broad authority to order relief that facilitates a successful reorganisation.

Set-off and recoupment

An often-overlooked remedy, set-off arises from the settlement of mutual debts or accounts owed between a debtor and a creditor. The Bankruptcy Code codifies this common law remedy and in fact provides that the creditor has a secured claim to the extent of the value of its set-off claim. The debts owing must be owed to and from precisely the same legal entities and the debts must arise either both pre-petition or both post-petition. The debts do not, however, have to arise out of the same transaction. The exercise of a set-off remedy requires relief from the automatic stay from the Bankruptcy Court.

Recoupment is similar to set-off, except that the mutual debts must arise from the same transaction.

Disclosure

The Bankruptcy Code provides all creditors various substantial rights to learn details about the debtor's financial condition, historical transactions and prospects for reorganisation.

Involuntary petition

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 $13,475 for 2008, 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.

During the "gap" period (time period between the date of the involuntary petition and the date a Bankruptcy Court enters an order for relief), there are pertinent rules on dealing with an entity during the gap period.

Part II of this article will address issues including additional creditor remedies, executory contracts, proofs of claim, Section 363 sales of assets, plans of reorganisation, avoidance actions and Chapter 15 regarding cross-border insolvencies. A more comprehensive version of this article is also available directly from the author, dconaway@slk-law.com.

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