Business Bankruptcy

Executive Summary: Need to Know Bankruptcy Concepts

By David H Conaway

In this first part of his article, David sets the parameters for understanding U.S. bankruptcy concepts...

According to the American Bankruptcy Institute, total commercial Chapter 11 filings in July 2021 decreased 62 percent from the previous year. Commercial Chapter 11 filings totaled 244 in July 2021, down from the July 2020 total of 644.

Lender forbearance, continued low interest rates and massive financial intervention by the U.S. and economies worldwide have allowed financially distressed companies to survive during the pandemic. As relief programs recede, however, we will likely see an increase in Chapter 11 filings.

In fact, in 2020, the Office of the Comptroller of the Currency (the OCC is the federal oversight agency for commercial banks and thrifts) issued OCC Bulletin 2020-21, which essentially stated that banks should not label any loan as a troubled debt restructuring through December 31, 2020.

The OCC subsequently issued OCC Bulletin 2020-35 extending this guidance through December 31, 2021. Many experts do not expect further extensions from the OCC, which will likely cause a surge of insolvencies in 2022.

Accordingly, the following is an executive summary of the "need to know" bankruptcy concepts as they impact creditors in business insolvencies.

CHAPTER 11 vs. CHAPTER 7

Chapter 11 is technically used for bankruptcy reorganizations, while Chapter 7 applies to liquidations. Chapter 11 and Chapter 7 can apply to either business or individual bankruptcies.

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.

Many lenders, who assert liens on substantially all of a debtor's assets, often prefer a "liquidating" Chapter 11 because of the Bankruptcy Code's unique provisions, which allow debtors to sell assets free and clear of liens (with liens attaching to proceeds), thus enabling a debtor to deliver "clear" title to prospective buyers. Many buyers insist that their

purchase of assets be conducted through a Section 363 sale in a liquidating Chapter 11.

AUTOMATIC STAY

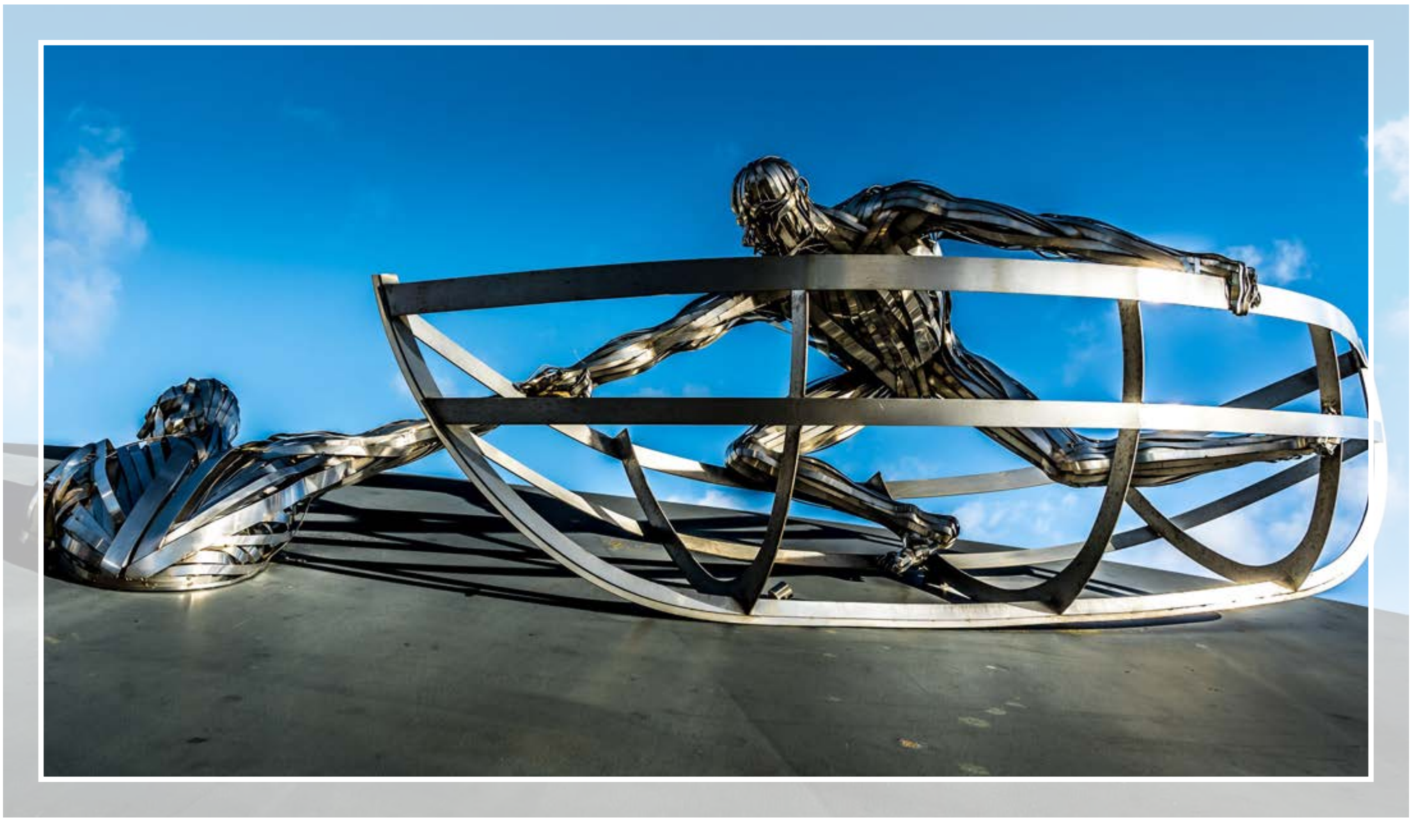
To promote the bankruptcy concept of providing "breathing room" to debtors, after a voluntary bankruptcy petition is filed, the Bankruptcy Code enjoins any action to collect pre-petition debts owed to creditors. This would include commencing or continuing a lawsuit, entering or enforcing a judgment, exercising a right of setoff, 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.

Stay violations can result in claim elimination, penalties, sanctions including attorneys' fees for the debtor's counsel, and, if appropriate, punitive damages.

FIRST DAY MOTIONS

In almost every Chapter 11 proceeding, the debtor will file a number of "first day" motions



which are usually 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. Perhaps the most substantive first day motion is 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.

For these reasons, it is common for a debtor and its lender to reach a consensual post-petition financing arrangement, called DIP financing.

Very often the lender has a superior negotiating position and thus the DIP financing agreement appears one-sided. 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.

Clearly there are substantive rights of other creditor constituents that can be compromised as a result of a DIP financing, and creditors' committees often file objections to DIP financing proposals.

In light of the global pandemic, lenders' willingness and perhaps ability to make DIP loans has been impacted.

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. At one time, critical vendor motions were also included in the "first day" motions. However, the current trend is for courts to delay consideration of any critical vendor motion until various parties, including the unsecured creditors' committee, have been given an opportunity to evaluate the motion.

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.

- To remain competitive, vendors are sometimes compelled to extend credit terms to Chapter 11 customers. In this event, creditors should carefully evaluate the risk of non-payment in Chapter 11.
- The Bankruptcy Code treats credit extended to a Chapter 11 debtor in the ordinary course of business as an administrative expense priority claim. As indicated below, administrative expense claims enjoy "high priority" and are generally paid, absent an "administrative insolvency."
- By contrast, extensions of credit that are not in the ordinary course of business must first be approved by the Bankruptcy Court, or they are not entitled to administrative expense priority treatment.
- Commonly, at the time of the Chapter 11 filing vendors have open purchase orders from debtors which arose prior to the Chapter 11 filing and provide for post-petition shipment by the vendor.
- Vendors should be aware that bankruptcy courts have denied administrative expense priority status for post-petition shipments on pre-petition purchase orders because the shipment arose from a pre-petition contract.
- The practical solution to this problem has been for vendors to require the pre-petition 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 having to re-issue purchase orders.

In one Bankruptcy Court ruling, a vendor sold goods to a Chapter 11 debtor on a cash before delivery basis. The Court later ordered the vendor to disgorge the payments received, since the debtor did not have authority to use its cash (pledged to a lender) pursuant to a DIP financing or cash collateral order.

In the case of a pre-petition supply contract which provides for credit terms, debtors may assert that such contracts impose an obligation on the vendor to extend credit.

While Bankruptcy Courts usually compel a vendor who is a party to a supply contract to ship goods, Bankruptcy Courts rarely force a vendor to extend credit to a Chapter 11 debtor.

Since a Chapter 11 filing effectively relieves the debtor of pre-petition debt, the debtor's post-petition cash flow may actually be healthier than it was pre-petition.

However, creditors should independently evaluate the risks of extending credit to a Chapter 11 debtor.

A key component of this evaluation should be the debtor's DIP financing and its impact on the debtor's working capital requirements.

SCHEDULES OF ASSETS AND LIABILITIES/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 lists the debtor's assets and values, the names of secured and unsecured creditors, the amount of the indebtedness and states whether or not the indebtedness is disputed. The Schedules also contain a list of equity holders and contracts to which the debtor is a party. The Statement of Financial Affairs includes a disclosure of the location of books and records, 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, as a result of pre-petition consensual liens on assets and proceeds of assets.
- Administrative claims, which are the costs associated with the administration of the post-petition bankruptcy estate. These would include purchases of goods and services post-petition as well as professional fees associated with the administration of the bankruptcy estate.
- Claims arising during the "gap" period, which is the

time period between the filing of an involuntary petition by three or more creditors and the date on which an order for relief is entered by the Bankruptcy Court.

- Employee wage claims of not more than $13,650 for 2021.
- Certain employee benefit contribution claims, as defined by the Bankruptcy Code, of not more than $13,650 for 2021.
- Deposit claims of not more than $3,025 for 2021 for deposits made by individuals for the purchase of goods or services for family or household use.
- Certain government tax claims as defined by the Bankruptcy Code.
- Allowed unsecured claims of a Federal Depository Institution regarding capital requirements of an insured depository institution.
- General unsecured claims.
- Equity interests.

General unsecured claims. Equity interests.

Secured, administrative and priority claims are generally paid in full while unsecured claims are rarely paid in full and in fact rarely receive any material dividend. Equity interests are almost always canceled at no value.There are many exceptions to the general rules.

In the case of an "administrative insolvency," the value of the debtor's assets are insufficient to pay the lender's claims and also the administrative claims. With increasing frequency, and as a result of very high loan to collateral value ratios, assets are insufficient to pay lenders in full much less claims "below the line."

Often, lenders find it necessary to pay professional fees associated with negotiating and closing a sale of its collateral in connection with a Bankruptcy Code Section 363 sale. Lenders often resist paying other administrative claims, creating lack of equality in treatment of similarly situated claims.

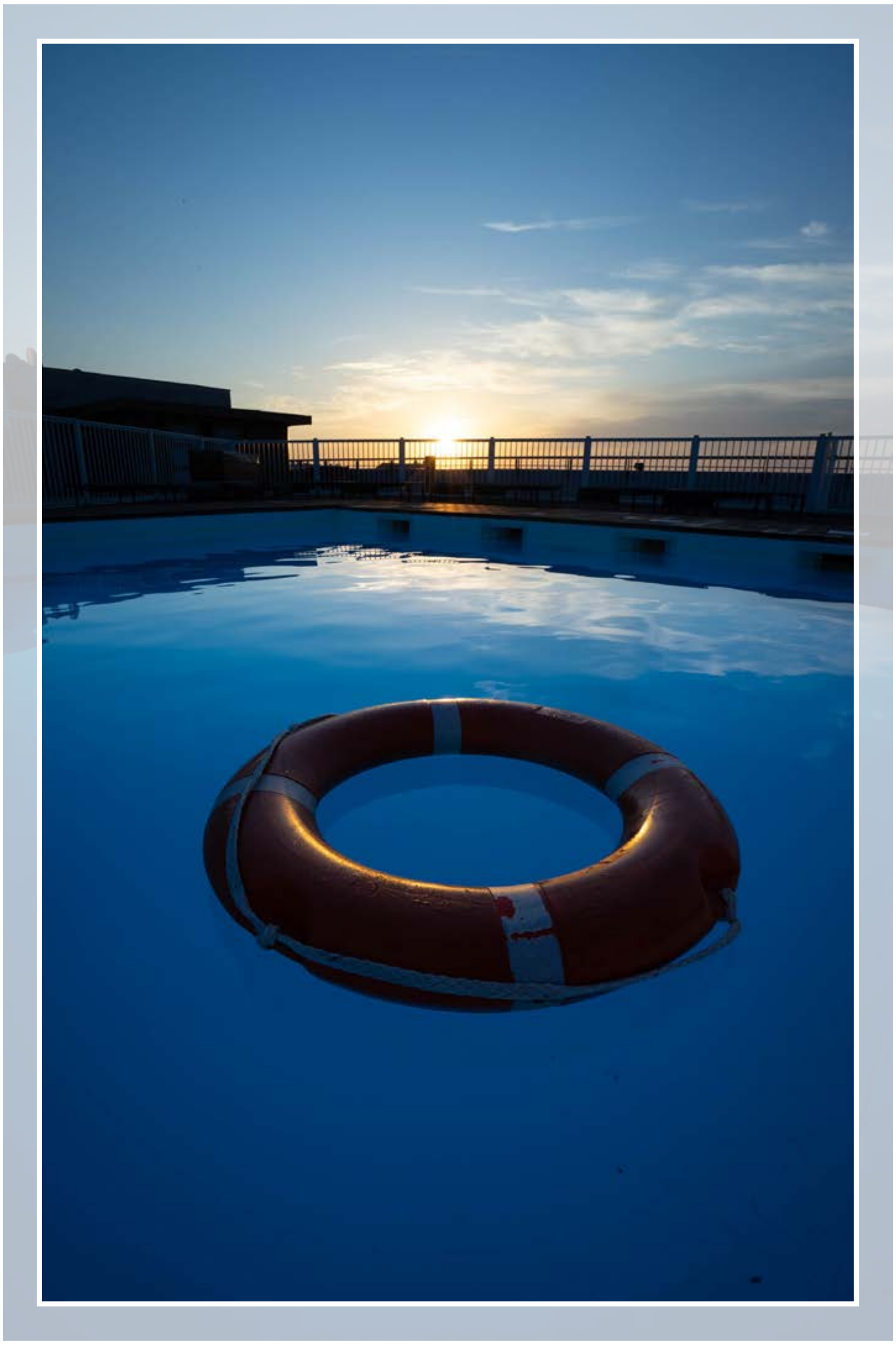
Absent an administrative insolvency, administrative claims are generally paid in full, as the Bankruptcy Code requires this as a condition precedent to confirmation of any plan of reorganization.

Moreover, while not a specific requirement of the Bankruptcy Code, a debtor is generally obligated to "pay as it goes" while in Chapter 11, meaning it must be able to pay its ongoing administrative claims in the ordinary course of business. A material build-up in unpaid administrative claims indicates a potential inability to obtain plan confirmation, and thus, provide grounds for a conversion of the Chapter 11 proceeding to a liquidation proceeding under Chapter 7.

SECURED CREDITOR ISSUES

Banks or other lenders who provide working capital or other loans to customers occasionally face a default under the loan and a subsequent Chapter 11 filing by the customer. Often, the secured lender has a lien on substantially all of the Chapter 11 debtor's assets.

At the outset, secured lenders decide whether to support the Chapter 11 debtor for a reorganization, or whether the best course of action is a liquidation of the lender's collateral, often in the form of a Section 363 sale of substantially all of the debtor's assets.



Regardless of whether the Chapter 11 case is a reorganization or a "liquidating 11," there is usually some form of debtor-in-possession financing provided by the secured lender.

Debtor-in-possession financing must be approved by the Bankruptcy Court, after notice of hearing to all creditors. Lenders may elect to not provide debtor-in-possession financing, in which case Chapter 11 debtors could seek Bankruptcy Court authorization to use "cash collateral," which is the cash generated from the lender's collateral, such as accounts receivable. The Bankruptcy Code provides that the debtor may not use "cash collateral" unless the lender consents, or the Bankruptcy Court so orders.

Sometimes secured lenders seek relief from the automatic stay, to allow the lender to pursue state law remedies, primarily Article 9 of the Uniform Commercial Code. Key issues in whether or not the lender is able to obtain relief from stay are: the value of equity in the lender's collateral in excess of the debt owed and the debtor's ability to successfully reorganize.

In connection with a Section 363 sale of substantially all of the debtor's assets, the Bankruptcy Code allows the secured lender to "credit bid" its debt as a potential bidder. Recent court decisions have affirmed a secured lender's ability to credit bid; however, at least one court limited the right to credit bid to the amount paid for the debt, not the face amount of the debt.

CREDITOR REMEDIES

20 Day Administrative Claim

The 2005 Bankruptcy Code Amendments added Section 503(b)(9) to the Bankruptcy Code, which provides that sellers of goods are entitled to an administrative priority claim for the value of goods received by the debtor within 20 days prior to the bankruptcy filing. Generally, such claims fare significantly better than general unsecured claims, and often receive 100% payment.

The case law addressing Section 509(b)(a) provides some predictability on how this remedy will benefit vendors.

There are two essential components to the 20 day administrative claim:

1: getting the claim allowed as an administrative claim in the first instance; and

2: getting the claim paid by the bankruptcy estate. 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. As a result of the general rule that unsecured claims receive little or no distribution and administrative claims are generally paid in full, converting any portion of an unsecured claim to administrative claim is a material achievement.

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. As with any other administrative claim, if the Chapter 11 proceeding is administratively solvent, payment of the 20 day administrative claim is probable. In cases where the debtor's Chapter 11 proceeding is "administratively insolvent," the likelihood of payment is compromised. However, payment on such claims nevertheless exceeds what would be paid absent the 20 day administrative claim.

Reclamation

Historically, reclamation was a standard vendor remedy. Reclamation is a state law remedy arising from the Uniform Commercial Code's provisions on sales of goods. In particular, most states allow a vendor to reclaim goods delivered to a customer (or stop goods in transit), if the seller learns of the customer's insolvency.

Prior to the 2005 Bankruptcy Code Amendments, the Bankruptcy Code recognized the state law remedy of reclamation but also recognized that permitting vendors to reclaim goods would be disruptive to a debtor's attempted reorganization. Accordingly, the Bankruptcy Code allowed a bankruptcy judge to grant a lien or administrative claim to the seller in lieu of the actual return of goods.

The 2005 Bankruptcy Code Amendments eliminated the provision allowing a bankruptcy judge to grant a lien or administrative priority in lieu of the actual return of goods. Accordingly, it is unclear what value the current reclamation claim will have.

Sellers of goods should nevertheless continue the practice of sending a reclamation demand which must be sent within 20 days after the Chapter 11 filing and can cover invoices for goods delivered within 45 days prior to the bankruptcy filing.

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 reorganization. In these instances, a bankruptcy court has broad authority to order relief that facilitates a successful reorganization. Only a debtor can make the determination that a particular vendor is critical and seek court approval of same. A creditor cannot independently impose its critical vendor status on a debtor. Critical vendor payments were controversial in the Kmart case, and since then courts have more closely scrutinized debtors' critical vendor proposals. Some jurisdictions refuse to entertain critical vendor motions. However, Delaware and New York continue to be jurisdictions where critical vendor payments can be approved in appropriate circumstances.

- Point of Interest: The Southern District of Texas has recently become a Chapter 11 hub, based in large part on the troubled energy sector and also the "complex case" system that assigns all large Chapter 11 cases to either Chief Judge David Jones or Judge Marvin Isgur.

Vendors who are truly critical to a debtor-customer should continue to seek critical vendor status as a means of getting paid. In doing so, vendors should be careful to not violate the automatic stay by conditioning future business on payment of pre-petition debt. Moreover, vendors should be aware that getting paid as a critical vendor will likely be conditioned on providing normal lines of credit, pricing and terms, or other "customary trade terms." It is most important that vendors calculate the amount and risk of payment of the required post-petition extensions of credit, compared to the amount of the critical vendor payment. There have been numerous instances, recently, where vendors have elected to not accept critical vendor payments due to the amount and risk of the post-petition extensions of credit.

Setoff and Recoupment

An often overlooked remedy, setoff, arises from the settlement of mutual debts or accounts owed between a debtor and a creditor. Simply, if A owes B $100 and B owes A $50, then the debts can be resolved as follows: $100 - $50 = $50, so A pays B $50 and the accounts are settled. 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 setoff 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 Delaware Bankruptcy Court has ruled that a debtor can set off a prepetition claim against a creditor against that creditor's allowed Section 503(b)(9) administrative priority claim instead of that creditor's general unsecured claim. The exercise of a setoff remedy requires relief from the automatic stay from the Bankruptcy Court. Moreover, there are somewhat complicated rules regarding exercise of setoff during the 90 days prior to the bankruptcy filing, which if not followed, could result in preference exposure. Recoupment is similar to setoff, except that the mutual debts must arise from the same transaction. The distinction can be important in certain situations:

A right of recoupment, for example, is not subject to the automatic stay or avoidable as a preference. Rights of setoff and recoupment can be waived. Creditors need to review contracts, Chapter 11 plans, DIP financing orders, and 363 sale orders carefully to determine whether they contain any provisions affecting rights of setoff or recoupment. Despite not being subject to the automatic stay, seeking relief from stay may avoid any uncertainty regarding whether the right being exercised is in the nature of setoff or recoupment and the possibility of the debtor later alleging the creditor exercised a right of setoff in violation of the automatic stay. We have noted a significant increase of sale contracts providing rebates and other sales incentives to the customer. Under applicable law, suppliers may setoff or recoup these obligations owed to customers against the accounts receivable owed. This effectively provides the supplier a 100% recovery to the extent of setoff or recouped amount.

Upon a Chapter 11 filing, suppliers should press pause on issuing rebate payments to first evaluate potential setoff rights. ■

The conclusion to this article will be published in the March 2022 edition.

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