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Business Bankruptcy: Executive Summary - Need to Know Bankruptcy Concepts

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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 world-wide 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 (OCC), 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 a 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’s 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.
- 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, provides 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 DIP financing provided by the secured lender.
- DIP financing must be approved by the Bankruptcy Court, after notice of hearing to all creditors. Lenders may elect to not provide DIP 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 (UCC). 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 percent 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 UCC'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 procedures."
- 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 pre-petition 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 percent 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.

- 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 petetion;

        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 debst 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 creditor's 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 ("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

- <u>Preferences</u>.
    - 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) two (2) years from the petition date or (b) one (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 Southern District of New York (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.

- <u>Fraudulent Transfers</u>.
    - 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

      Goal: to "modernize and harmonize the rules on international business and to enhance predictability in cross-border commercial transactions."

    - European Union Regulation on Insolvency Proceedings
    - 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.

- See Article: *Chapter 15 and Cross-Border Insolvency* for in-depth analysis.