2 A Creditor's Guide to the Bankruptcy Process

STRUCTURE OF THE BANKRUPTCY CODE

Bankruptcy law presently in effect in the United States is referred to as the United States Bankruptcy Code. It is found in Title 11 of the United States Code and is referred to as "11 U.S.C. §____." All references in this text to "11 U.S.C. §____" are references to the Bankruptcy Code. The Bankruptcy Code was first adopted in 1978 and became effective October 1, 1979. The Bankruptcy Code has been amended from time to time since October 1, 1979. The most recent amendments to the Bankruptcy Code, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), modified the Bankruptcy Code in a greater manner than any of the prior law changes containing the most substantive changes made since the original 1979 enactment. It must be understood that although BAPCPA, itself, contains numerous titles and sections, all the permanent changes are referenced in the Bankruptcy Code. One of the major revisions made by BAPCPA is the addition of a new Chapter 15 to the Bankruptcy Code, titled "Ancillary and Cross-Border Cases." Further, Title X of BAPCPA, titled "Protection of Family Farmers and Family Fishermen," has added substantive changes to the Bankruptcy Code.

The Bankruptcy Code itself is broken down into nine chapters. The first three chapters, Chapters 1, 3 and 5, contain administrative provisions that apply in all cases under the Code. For example, the mechanics for filing a petition for relief, the provisions for compensation of professionals and the general definitions are all found in the first three chapters and apply in all chapters. The remaining five chapters, Chapters 7, 9, 11, 12 and 13, are the operative chapters under which the various types of bankruptcies are filed. Chapter 15 has been added to manage the many cases that are being filed with U.S. and foreign nation counterparts. Chapter 7 is a liquidation bankruptcy in which a trustee is appointed by the United States Trustee, or in rare cases, elected by creditors, to liquidate nonexempt assets. Chapter 9 is the municipal reorganization chapter. Chapter 11 is the reorganization chapter though it is often used as a liquidation context. Chapters 12 and 13 are specialized reorganization chapters for family farmers, fishermen and wage earners (including individuals who may operate small businesses, such as sole proprietorships, and who otherwise qualify under the debt limits).

The following is a summary of the Bankruptcy Code chapters followed by detailed explanation of Bankruptcy Code chapter, sections and changes that are most pertinent to commercial credit grantors.

Chapter 1
Code Sections 101 to 110—General Provisions and Definitions

Chapter 3—Case Administration
Code Sections 301 to 307—Commencement of the Case
Code Sections 321 to 331—Officers of the Estate
Code Sections 341 to 350—Administration of the Case
Code Sections 361 to 366—Administrative Powers

Chapter 5—Creditor, Debtor and the Estate
Code Sections 501 to 510—Creditors and Claims
Code Sections 521 to 525—Debtor's Duties and Benefits
Code Sections 541 to 560—The Estate and Avoidance Powers

Chapter 7—Liquidation
Code Sections 701 to 707—Officers of the Case
Code Sections 721 to 728—Collection, Liquidation and Distribution of the Estate

Code Sections 741 to 752—Stock Broker Liquidations
Code Sections 761 to 766—Commodity Broker Liquidations

Chapter 9—Adjustment of Debts of a Municipality
Code Sections 901 to 904—General Provisions
Code Sections 921 to 930—Administration
Code Sections 941 to 946—The Plan

Chapter 11—Reorganization
Code Sections 1101 to 1114—Officers and Administration
Code Sections 1121 to 1129—The Plan
Code Sections 1141 to 1146—Post-Confirmation Matters
Code Sections 1161 to 1174—Railroad Reorganizations

Chapter 12—Adjustment of Debts of a Family Farmer or Fisherman with Regular Annual Income
Code Sections 1201 to 1208—Officers, Administration and the Estate
Code Sections 1221 to 1231—The Plan

Chapter 13—Adjustment of Debts of an Individual with Regular Income
Code Sections 1301 to 1307—Officers, Administration and the Estate
Code Sections 1321 to 1330—The Plan

Chapter 15—Ancillary and Cross-Border Cases
Code Sections 1501 to 1508—Purpose, Scope and General Provisions
Code Sections 1509 to 1514—Access of Foreign Representatives and Creditors to Court
Code Sections 1515 to 1524—Recognition of a Foreign Proceeding and Relief
Code Sections 1525 to 1527—Cooperation with Foreign Courts and Foreign Representatives
Code Sections 1528 to 1532—Concurrent Proceedings

Bankruptcy practice runs on deadlines. All filings must be done in a timely manner including filing a proof of claim, objections to discharge, complaints to determine dischargeability, objections to sales and objections to confirmation of plans. It's important to understand that failure to comply with the Code's deadlines may dramatically affect the rights of the filer.

FEDERAL RULES OF BANKRUPTCY PROCEDURE

To complement the provisions of the Bankruptcy Code, Congress provided for the adoption of rules of procedure relating to bankruptcy cases. The Federal Rules of Bankruptcy Procedure are the result. The Bankruptcy Rules govern how bankruptcy cases are to proceed. While a credit grantor is not required to understand all of the rules, if the creditor acts outside of or in contravention to the rules, sanctions may be imposed by the Court, default or summary judgments may be entered, and rights lost. Therefore, it is very important that a creditor in a bankruptcy proceeding either fully understands the rules or seeks competent advice.

References in this text to the "Bankruptcy Rules" or "Fed. R. Bankr. P." are to the Federal Rules of Bankruptcy Procedure. The rules are broken down into 10 chapters and contain a number of deadlines and other requirements governing pleadings in the bankruptcy court. The Federal Rules of Bankruptcy Procedure also provide for the bankruptcy courts and the United States District Courts to adopt specific local rules. Most courts have adopted local rules governing such matters as the filing of pleadings and the establishment of trial dockets and motion practice. If there is a conflict between the provisions of the Bankruptcy Code itself and the various applicable rules, the Bankruptcy Code will control. Knowledge of the rules is essential to meeting deadlines. The creditor's library should include a current copy of the rules and a copy of the local rules of any bankruptcy court where papers are filed.

One of the most important changes to the rules of procedure with respect to the Bankruptcy Code has been the implementation of electronic filing in all U.S. bankruptcy courts.

AUTOMATIC STAY

Upon the filing of a bankruptcy petition, the Bankruptcy Code imposes a type of injunction, referred to as the automatic stay, which bars creditors' enforcement actions against the debtor or assets of the debtor. (11 U.S.C. §362). The automatic stay is imposed to further one of the Bankruptcy Code's principal goals of ensuring a fair distribution of the debtor's nonexempt, unencumbered assets among creditors. While creditors generally view the automatic stay as an infringement on their rights, it is actually designed to protect them. Without the automatic stay it would be possible for a creditor to conceal or seize assets of the estate even post-petition.

Once the filing of the petition has imposed the automatic stay, any action to collect the debt from the debtor or the debtor's property is prohibited. Note that the automatic stay is in force, even without notice to creditors, and in certain limited circumstances in Chapters 12 and 13, also protects consumer co-debtors and guarantors until the stay is lifted. Any action that violates the automatic stay may be set aside by the bankruptcy court. The court may also impose penalties. A violation of the automatic stay is a contempt of court and may be punished by an award of damages and attorney's fees against the person violating the automatic stay. Of particular interest to unsecured creditors is the fact that the automatic stay bars actions by governmental units such as the IRS and prevents the post-petition seizure of assets to satisfy IRS claims. The IRS and other tax authorities may continue tax assessments and audits and may demand filing of tax returns without violating the stay, but it may not impose a lien on the debtor's property, nor seize the debtor's property without permission of the bankruptcy court.

The automatic stay specifically prohibits the set-off of mutual debts without an appropriate court order. This, for instance, prevents a bank from seizing the debtor's deposits upon the filing of the bankruptcy, although the bank may retain a lien on any deposits. In a trade debt situation, the automatic stay would prevent the offsetting of any claims that may be owed the debtor against the debtor's debt, unless bankruptcy court approval is sought and obtained. The automatic stay will generally not, however, prevent the creditor from exercising rights under the UCC to stop goods in transit before delivery to the debtor or to demand reclamation of goods under 11 U.S.C. §546(c). There is also an exception to the automatic stay for mechanic's lien creditors. The automatic stay does not prevent a mechanic's lien creditor, whose lien arose prior to the bankruptcy filing, from perfecting or maintaining its lien post-petition if under state law, the creditor could have perfected or maintained its mechanic's lien and the lien rights relate back and have priority over any other entity acquiring rights in the property prior to perfection or maintenance of perfection.

In order to lift the automatic stay, a creditor must file a motion for relief from the automatic stay. The creditor must pay a filing fee unless the debtor or the trustee stipulates to the relief. The creditor should check with the appropriate clerk of court to confirm the current fee. Additionally, the website for the Judiciary home page www.uscourts.gov provides links to the bankruptcy courts, many of which post all of the filing fees as set by the Federal Judiciary Law. Motions for relief are generally handled on a notice and hearing basis. In routine Chapter 7 consumer cases there is rarely a hearing. The creditor seeking relief must show cause (e.g., lack of adequate protection of an interest in property), or must show that the debtor does not have any equity in such property and such property is not necessary for a successful reorganization. In a complicated Chapter 11 case, however, relief from the automatic stay is one of the first major battles in the reorganization process.

As an unsecured creditor or a member of an unsecured creditors' committee, the unsecured creditor and counsel will need to be concerned that any relief from the stay does not adversely affect the ability of the debtor to reorganize. Since most motions for relief are heard on a notice and hearing basis, the creditor should consult counsel upon receiving a copy of the notice to determine whether any objection is necessary or appropriate. Fed. R. Bankr. P. 4001(d) has been amended as it relates to motions to approve agreements relating to relief from the automatic stay as well as agreements regarding the use, sale or lease of property; providing adequate protection; use of cash collateral; and obtaining credit.

The automatic stay provisions deal with the abuse of serial bankruptcy filings. The availability of the automatic stay is limited when a debtor refiles a bankruptcy following the dismissal of a prior bankruptcy. First, when an individual debtor files a bankruptcy case under Chapter 7, 11 or 13, within

one year after dismissal of a prior bankruptcy case, the automatic stay terminates within 30 days of the later bankruptcy case. This does not apply where the debtor's prior case was dismissed as a result of the debtor's inability to comply with the "means test."

First, when an individual debtor files a bankruptcy case under Chapter 7, 11 or 13, within one year after dismissal of a prior bankruptcy case, the automatic stay terminates within 30 days of the later bankruptcy case. This does not apply where the debtor's prior case was dismissed as a result of the debtor's inability to comply with the "means test."

The debtor could have the bankruptcy court extend the automatic stay beyond the initial 30-day period if the court finds the later filing was in good faith. However, a bankruptcy case is presumed to have been filed in bad faith if: (1) there was a prior bankruptcy case where the debtor had failed to: (a) file schedules or other documents as required by the Bankruptcy Code or Rules or court order; (b) provide adequate protection as directed by the court; or (c) perform under a confirmed plan; (2) there has not been a substantial change in the debtor's financial or personal affairs or any other reason to conclude that the case will not be concluded, if Chapter 7, with a discharge and if Chapter 11 or 13, with a confirmed plan that will be fully performed; or (3) as to any creditor who had filed a lift stay motion that was pending or granted in the prior case. The debtor can rebut any such presumed bad faith bankruptcy filing by the difficult to prove clear and convincing evidence standard.

If an individual debtor had filed two or more Chapter 7, 11 or 13 cases during the year preceding the debtor's bankruptcy filing, the automatic stay will not apply in the debtor's subsequently filed bankruptcy case, unless the prior cases were dismissed because the debtor had failed the "means test." The debtor could have the stay reimposed by moving for court approval within 30 days of the later filing and proving the filing was in good faith. Similar presumptions of bad faith apply here too.

Further, the automatic stay with respect to the debtor's real property could be terminated if the court finds that the bankruptcy filing was part of a scheme to hinder, delay, or defraud the debtor's mortgage creditors by either transferring ownership of the property or filing multiple bankruptcy cases involving the property. If the mortgage creditors record the order terminating the stay as to the real property under state law, that order would be effective for two years following entry of the order and would apply to subsequent bankruptcy cases affecting the real property. The debtor could obtain relief from the order in a subsequent case by showing good cause or changed circumstances.

Finally, there are specific exceptions to the general rules of an automatic stay in small business cases. The automatic stay does not apply in a case in which the debtor has a small business case pending at the time a petition is filed. The automatic stay also does not apply if the debtor was a debtor in a small business case that was dismissed or confirmed within two years from the filing of a subsequent petition. Likewise, if the debtor is an entity that acquired substantially its assets or business from a small business debtor, the automatic stay does not apply unless the entity can prove that it acquired these assets or business in good faith and not merely to have the automatic stay imposed.

ADMINISTRATION OF A TYPICAL CHAPTER 7 CASE

While a detailed discussion of Chapter 7 is beyond the scope of this text, the basic elements of a Chapter 7 need to be understood, particularly to fully understand and appreciate the alternatives available in reorganizations under Chapter 11. Chapter 7, also referred to as "straight bankruptcy" or "liquidation," is by far the most common type of bankruptcy filing in the United States. The overwhelming majority of cases filed in bankruptcy court are in Chapter 7. Generally, most of them are consumer cases.

Bankruptcy Abuse

In order to be eligible to seek Chapter 7 bankruptcy relief, an individual debtor must seek credit counseling within 180 days before he files his petition, and pay a filing fee. The Chapter 7 will be dismissed if that individual debtor fails to seek credit counseling. In addition, an individual with predominantly consumer debts who files for Chapter 7 must pass what has commonly become known as the "means test." This test takes into consideration the debtor's current monthly income, which is defined as:

1. The average monthly income from all sources that the debtor receives (or in a joint case the debtor and the debtor's spouse receive) without regard to whether such income is taxable income, derived during the six-month period ending on the last day of the calendar month immediately preceding the date of the filing of the debtor's petition; or in the event the debtor does not file the requisite schedule of current income now required, then the date on which current income is determined by the court for purposes of this section.
2. Current monthly income includes any amount paid by a third party on a regular basis for the household expenses of the debtor or the debtor's dependents but excludes:
   a. Social Security benefits;
   b. Payments to victims of war crimes or crimes against humanity on account of their status as victims of such crimes; and
   c. Payments to victims of international terrorism on account of their status as victims of such terrorism.

In determining this "means test," the debtor's current monthly income is reduced by certain monthly expenses. Those necessary monthly expenses are divided into two categories. The first set of expenses is rigid and shall include:

1. Applicable monthly expense amounts specified under the National Standards and Local Standards.
2. Actual monthly expenses for the debtor, the debtor's dependents and spouse (if a joint case and unless the spouse is also a dependent) for categories specified by the Internal Revenue Service for the area in which the debtor resides. If the debtor demonstrates necessity, then an additional allowance for food and clothing as categorized by the National Standards issued by the Internal Revenue Service.
3. Reasonably necessary expenses for health insurance, disability insurance and health savings account expenses for the debtor, spouse of the debtor and the debtor's dependents.
4. Reasonably necessary expenses to maintain the safety of the debtor and the debtor's family from family violence as identified in Section 309 of the Family Violence Prevention and Services Act or other federal law.

The second set of expenses is permissive and may include, if applicable:

1. The continuation of actual expenses paid by the debtor that are reasonable and necessary for care and support of an elderly, chronically ill or disabled household member or member of the debtor's immediate family (including parents, grandparents, siblings, children and grandchildren of the debtor, the dependents of the debtor, and the spouse of the debtor in a joint case who is not a dependent) and who is unable to pay for such reasonable and necessary expenses.
2. The actual administrative expenses of administering a Chapter 13 plan, if the debtor is eligible for Chapter 13, up to 10 percent of the projected plan payments, as set forth in schedules established by the Executive Office for the United States Trustee.
3. The actual expenses, for each dependent under 18 years of age, up to $1,925 per year per child, to attend a private or elementary school if the debtor provides documentation of the expenses and can establish that the expenses are reasonable and necessary and not already included in any of the rigid expenses described above.
4. The actual expenses for housing and utilities, in excess of the local standards for housing and utilities if the debtor provides documentation of the actual expenses and can establish that the expenses are reasonable and necessary.

In order to determine whether there is bankruptcy abuse, the debtor's monthly income, after the allowed expenses as delineated above, is multiplied by 60. Substantial abuse will be found to exist if the resulting monthly income of the debtor is:

(1) not less than the lesser of 25 percent of the debtor's nonpriority unsecured claims in the case, or $7,700, whichever is greater; or

(2) $12,850.

There is provision for the debtor's average monthly payments on account of secured debts to be calculated as the sum of:

(1) the total of all amounts scheduled as contractually due to secured creditors in each of the 60 months following the date of the petition; and

(2) any additional payments to secured creditors necessary for a Chapter 13 debtor to maintain possession of:

(a) the debtor's primary residence;

(b) the debtor's motor vehicle; and

(c) other property of the debtor necessary for the support of the debtor and his dependents, which property serves as collateral to secured creditors.

These sums are then divided by 60. Further debtor's expenses for payment of all priority claims, including child support and alimony, are calculated as the total of those debts divided by 60.

In order to overcome a presumption of abuse, an individual debtor may show special circumstances that justify additional expenses or adjustments to his current monthly income for which there is no reasonable alternative. These special circumstances can be proven by documentation evidencing the expense or adjustment to income, and a detailed explanation as to the special circumstances that make such expense or adjustment to income necessary and reasonable. The congressional record[1] states that these special circumstances may include a serious medical condition, or a call to active duty in the United States Armed Forces, to the extent such special circumstances justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative.

In the vast majority of the cases there are no assets for administration, and the case is closed shortly after the §341 meeting. Again, practice varies from one part of the country to another, but generally the United States Trustee will approve a no asset report and the court will close the case within 180 days of the filing of the case. In the cases in which there are assets for distribution, the trustee will generally take possession of them through agents and begin making arrangements for their liquidation.

The trustee will generally liquidate assets through a notice and sale procedure. The trustee will give notice of the intended sale to all creditors, listing the assets to be sold and specifying the terms of sale, whether private sale, auction, etc. There will be an opportunity to object to the proposed sale, but the objection must be filed before the date specified in the notice of sale. Generally, the sale will be free and clear of liens so that the purchaser takes clear title to the property. If there is a security interest in the property, the secured creditor should make sure that the security interest is recognized and that the trustee turns over all proceeds of the collateral to the creditor.

Chapter 7 Trustee

In all cases under Chapter 7, a trustee is appointed whose primary responsibility is to take possession of any nonexempt assets and sell them for the benefit of creditors. Ninety-five percent of the cases involve no distributable assets. Even in a majority of the business cases, most of the assets are fully encumbered and there is nothing for the trustee to sell for the benefit of the estate.

In a typical Chapter 7 case, after the debtor has filed the bankruptcy petition and paid the filing fee, the United States Trustee appoints an interim trustee. The exceptions are North Carolina and Alabama where the bankruptcy court makes the appointment. Generally, the trustee will be an attorney or an accountant with experience in bankruptcy. The United States Trustee is required by statute to maintain a panel of private trustees to serve in bankruptcy cases in those districts for which the United States Trustee is responsible. Trustees are appointed to the panel after an FBI background

[1] The congressional record refers to the text from House Report 109-031 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

investigation and credit check. Typically, the trustees are selected at random from the panel of trustees to handle a particular case. Occasionally, a case will have substantial assets or involve the operation of a business and require special expertise. Only then will the United States Trustee consider going outside the panel and select a businessperson to serve as trustee.

The interim trustee's first duty is to review the file and take possession of the debtor's unencumbered and non-exempt assets.

The second duty for the interim trustee is to preside at the §341 meeting of creditors. Occasionally, at the §341 meeting creditors elect a new trustee under 11 U.S.C. §702. The process for electing a trustee is somewhat arcane. To be eligible to vote, a creditor must hold an allowable, undisputed, liquidated, unsecured claim. Further, the creditor may not have a materially adverse interest and may not be an insider. Generally, it is necessary to file a proof of claim before participating in an election. The interim trustee must conduct the election at the §341 meeting if creditors eligible to vote and who hold at least 20 percent of all of the undisputed unsecured claims request an election. Creditors then vote their claims and, if at least 20 percent of the allowed claims vote in the election and a candidate for trustee receives a majority of those votes cast, that person is elected as trustee. It is extremely rare that creditors will choose to elect a Chapter 7 trustee.

Duties of a Trustee

A trustee, whether elected or otherwise, has certain duties that are specified in 11 U.S.C. §704. These duties were expanded by BAPCPA. Generally, the trustee must sell any unencumbered, non-exempt assets of the estate and account for the proceeds to creditors. The trustee must investigate the financial affairs of the debtor, examine proofs of claim and object to their allowance, if a purpose would be served, and oppose the discharge of the debtor, if advisable. The trustee also investigates possible claims for preference recovery and fraudulent transfer. Most trustees will carefully scrutinize a secured creditor's documentation to determine whether there is any possibility for avoiding the security interests claimed under the trustee's avoidance and strong arm powers. (*See* 11 U.S.C. §§544, 547 and 548 and the discussion of the trustee's powers below.) On occasion the trustee may be authorized to operate the business of the debtor on a limited basis.

Some of the areas in which the trustee has additional duties imposed by BAPCPA are where a debtor:

- Owes a domestic support obligation.
- Is a health care business.
- Served as the administrator of an employee benefit plan.

Specifically, with respect to individual Chapter 7 proceedings, a Chapter 7 trustee must, within 10 days after the date of the first meeting of creditors, file with the court a statement as to whether the debtor's case would be presumed to be an abuse under Section 707(b). If such statement is filed, then within 30 days after filing said statement, the Chapter 7 trustee must either file a motion to dismiss or to convert the Chapter 7 proceeding to one under Chapter 11 or 13.

Distribution of Assets

The distribution of assets in a bankruptcy estate is governed by the provisions of the Bankruptcy Code based upon the type of claim that is held by the creditor and the order of distribution entered by the court. Oftentimes, creditors do not file a proper proof of claim where they are entitled to secured or priority status and, as such, do not receive a maximum distribution. Understanding the types of claims and the distribution method is very important.

Eventually, the trustee will wind down all of the litigation, resolve all objections to claims and be prepared to distribute the funds. The trustee will file a final report with the court and, with the approval of the United States Trustee, seek to close the case. Procedures again vary from one part of the country to another, but generally notice will be given of a final hearing on the case or an opportunity to request a final hearing. If a hearing is scheduled, generally the trustee must appear before the court will award fees. In most cases, however, trustees notice out the intended distribution of the

estate assets, including payment of their fees, and if no objection is filed within the deadline established by the court, no final hearing is held and the distribution is approved as noticed. If the creditor has an objection to the intended distribution or the requested fees and expenses, a written objection must be filed with the court within the deadline established in the notice. Note that the objection must reach the court prior to the deadline.

The trustees are required to satisfy claims in a particular order. Under 11 U.S.C. §507, administrative expenses of the estate have priority over all claims of creditors. Chapter 7 administrative expenses have priority over Chapter 11 administrative expenses. If the case were a Chapter 11 initially, any remaining administrative claims from the Chapter 11 proceeding must be paid. These include the "20-day" administration claim provided to certain trade creditors, that are goods sellers, under §503(b)(9). These also include claims for post-petition sales to a debtor in possession. Once all Chapter 7 administrative expenses and Chapter 11 administrative expenses are paid, the trustee will then proceed to distribute the assets to all other creditors. Certain creditors who hold wage, salary, commission, vacation, severance and sick leave claims of up to $12,850 earned within 180 days before the bankruptcy filing date; claims for contributions to an employee benefit plan of up to $12,850 per employee, less the amounts paid on account of employees' wage, salary and related compensation priority claims; and consumer deposit claims of up to $2,850 per customer are paid in the order specified in Section 507(a) before any distribution is made to general unsecured creditors. Note also that there is a first level of priority claims for domestic support obligations. Finally, tax claims have a priority behind the foregoing categories of priority claims, and quite often the tax claims will absorb any funds remaining after the other priorities are satisfied, leaving nothing for the unsecured creditors.

It is not uncommon for the trustee to overlook a claim or simply omit a claim from an intended distribution. If a proof of claim is filed and the creditor is not listed as one of the potential distributees, the creditor must file an objection and review the case with the trustee to determine why the claim, as filed, was not included in the distribution. If no objection is made, the court may approve the distribution without payment being received by the creditor.

TRUSTEE'S COMPENSATION

Chapter 7 trustees are paid compensation per each case handled. (11 U.S.C. §330). In addition, the court will usually allow the Chapter 7 trustee to receive a percentage of the assets distributed to creditors. (11 U.S.C. §326). Maximum fees for Chapter 7 trustees and Chapter 11 trustees may not exceed 25 percent of the first $5,000; 10 percent of any amount in excess of $5,000, but not in excess of $50,000; five percent on any amount in excess of $50,000 but not in excess of $1,000,000; and three percent of any amount in excess of $1,000,000. Note that these fee caps are the statutory *maximums* the court may approve in any case. Monies turned over to the debtor and to secured creditors from the sale of property subject to liens are not subject to the trustee's fees. The compensation is generally considered inadequate. Particularly in the no asset cases where the trustee receives only the statutory fee, currently set at $325, this fee is insufficient to cover the trustee's costs and time in reviewing the file, conducting the §341 meeting and filing reports with the United States Trustee and the court. This has become truer than ever with the increased duties of the trustee imposed by BAPCPA. The tendency, therefore, is for the court to award the maximum compensation possible in the asset cases.

Trustees are entitled to reimbursement of expenses from the estate. The type of expenses reimbursed will vary from fees for lawyers, accountants and realtors to the cost of preparing assets for sale, costs of sale notices and virtually all other expenses necessary to the administrative process. Trustees are not entitled to recover office overhead, however. It is routine practice for the trustees in most districts to employ themselves as attorneys for the trustee at the expense of the estate. Some courts have suggested that this raises a conflict of interest since the trustee is not getting independent legal advice. Generally, the trustee will not be compensated for work done in the capacity of trustee, but only for legal work or other professional work on behalf of the estate.

Before the court can award fees and expenses, the court must give notice of the intended payment to the trustee and the professionals involved. There is an opportunity to object to the compensation and expenses and it should be done within the deadlines set out in the notice of the request for compensation.

Complaints about the Trustee

Even in those cases where the trustee is an attorney, the trustee cannot give legal advice on the claim or disputes with the debtor. The trustee is a fiduciary and holds the estate for all creditors. Thus, the creditor should not expect a trustee to respond to specific legal questions about how to proceed. Moreover, the trustee generally will not respond to requests for information in no asset cases. Many of the trustees handle dozens, if not hundreds, of cases in any given year and simply putting postage on repeated requests for information would exhaust the fees paid to the trustee. Creditors interested in determining the status of a Chapter 7 proceeding can use the PACER system to obtain electronically-based information about a particular case. The general PACER website is www.pacer.gov.

If there are concerns about the trustee's handling of a particular case, the creditor should retain counsel to object to the trustee's final report and bring the complaints before the court in that fashion. Other less formal complaints about a trustee's handling of a particular case or cases in general should be directed to the United States Trustee for the district in which the case is pending. The United States Trustee has general supervisory authority over Chapter 7 trustees and regularly audits their handling of cases. A locator for the United States trustees is found in Chapter 4. While the United States Trustee will discuss a particular trustee, they will not give legal advice on pursuing claims against an estate or against a trustee.

A Trade Creditor's Primary Concerns

Prompt Administration of the Estate

One of the primary concerns in any Chapter 7 case will be the prompt and efficient liquidation of the bankruptcy estate. In most cases simply monitoring the notices of sale and eventually the notice of distribution will be sufficient. There will be cases, however, in where there is information about the estate or the conduct of the debtor's business, which would be of use to the trustee in recovering funds. At the same time, if the debtor's assets include inventory or raw materials that have been sold to the debtor, the creditor may be able to repurchase the products from the estate more efficiently rather than having the trustee sell the inventory or materials to the general market.

The first decision, therefore, will relate to any involvement in the case. The creditor may simply choose to file a claim (after consulting counsel) and await the distribution. Or the creditor may, however, wish to contact the trustee and furnish information about possible fraudulent or preferential transfers, the value of inventory being held by the debtor or other information that will assist the trustee in recovering assets for the benefit of creditors.

Exemptions and Estate Planning

Trade creditors of businesses are finding themselves more often encountering a situation in which they have a claim against an individual. These cases will arise where the debtor is a guarantor or a sole proprietor of a business. The creditor will, therefore, need to review the exemptions that the individual is claiming, and may possibly need to determine whether the debtor has converted property that should be available to satisfy the claim into exempt property. The Bankruptcy Code permits the states to allow individual debtors to claim either state or federal exemptions in an effort to give the debtor a fresh start after bankruptcy. The debtor may convert nonexempt assets into exempt assets as part of the debtor's estate planning prebankruptcy. Creditors are given an opportunity to object to the debtor's exemptions, but must file the objection within 30 days of the conclusion of the §341 meeting. In order to make a decision on an objection, the creditor should be familiar with the exemption laws that apply in the state where the individual debtor is a resident and have some knowledge of the debtor's assets. Since an objection will generally require the assistance of counsel and because the time deadline is so short, the creditor should review the case as soon as notice is received to determine whether to object to the exemptions claimed by the debtor.

HOMESTEAD EXEMPTIONS

BAPCPA changed the Bankruptcy Code substantially in the area of homestead exemptions. First, the definition of homestead has been clarified to create consistency throughout the country. A homestead is defined as:

(1) real or personal property that the debtor or dependent of the debtor uses as a residence;
(2) a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence;
(3) a burial plot for the debtor or a dependent of the debtor; or
(4) real or personal property that the debtor or a dependent of the debtor claims as a homestead.

For those debtors who choose state exemptions, the homestead exemption is limited to no more than $160,375 in value that the debtor has acquired during the 1,215-day period preceding the filing of the petition. (*See* Chapter 9 "The Importance of Collections, Steps in the Collection Process and Special Collection Situations" in *Volume I: General Business Law, Related Statutes and Collections* for a fuller discussion of exemptions, including homestead exemptions.)

DISCHARGE LITIGATION

The Bankruptcy Code offers the honest debtor a new financial start through a discharge. Only individuals are granted a discharge. In certain circumstances, specific debts are not discharged or a dishonest individual may be denied a discharge completely. In those isolated instances dealing with an *individual* debtor who has filed a Chapter 7, the creditor may wish to review the case for a possible objection to discharge under §727 or to dispute the dischargeability of the debt owed under §523. The Bankruptcy Code allows creditors to object to the discharge or to determine nondischargeability if, among other things, the debtor has committed fraud in connection with the bankruptcy case or in connection with the extension of the credit. Any objection to discharge and most complaints to determine dischargeability in Chapter 7 must be filed within 60 days of the §341 meeting specified in the initial notice of the bankruptcy filing. BAPCPA expanded the bases under which a debtor can be denied a discharge. For example, an individual debtor who is guilty of securities fraud will not receive a discharge. Certain consumer debts or cash advances that are extensions of consumer debt are presumed to be nondischargeable. Domestic support obligations are exempt from discharge. For the general trade creditor, the kinds of debts for which a discharge might be refused, remain those that may have been incurred through fraud or through a false financial statement. In those cases, the creditor should review the case very promptly with counsel or the opportunity to object may be lost.

FILING A PROOF OF CLAIM

In a Chapter 7 bankruptcy, a creditor must file a proof of claim to participate in the distribution of estate assets. The Official Proof of Claim form is Form 410. Official Form 410 and instructions for the filing of a proof of claim are discussed below. Before filing a claim, the creditor should review with counsel any adverse claim that the debtor may have. The filing of a proof of claim has been held to waive a creditor's right to a jury trial on certain preference and fraudulent transfer actions and is generally considered to be sufficient to submit the creditor to the jurisdiction of the bankruptcy court for other purposes. Unless satisfied that the debtor has no potential claim for fraudulent or preferential transfer or other claim, the creditor should discuss the filing of a claim with counsel.

CHAPTER 11 REORGANIZATION PROCESS

A detailed analysis of Chapter 11 problems is beyond the scope of this text. The following is a general summary of Chapter 11.

Debtor in Possession

Upon filing a Chapter 11 petition under the Bankruptcy Code, the debtor continues to operate the business as a debtor in possession with the protection of the automatic stay. The debtor is referred

to as the "debtor in possession," the "debtor" or occasionally as the "trustee." Chapter 11 of the Bankruptcy Code uses the term "trustee" even though the debtor normally continues the operation of its business as debtor in possession. An actual trustee is only appointed by court order. The debtor in possession, however, has the status of a trustee in that the debtor must manage the assets of the estate for the benefit of creditors. The debtor also has the powers of the trustee, such as the strong arm powers and the preferential and fraudulent transfer avoidance powers discussed below. There is a provision, however, for the appointment of a trustee to operate the business under 11 U.S.C. §1104. (*See below*.)

Debtor in Possession Reporting

The debtor in possession is required to make periodic reports to the United States Trustee and the bankruptcy court. Those reports will generally be made available to interested creditors and the creditors' committee. The reports, which are standardized by the Office of the United States Trustee, include a balance sheet, a cash flow statement and statement of any unpaid liabilities for post-petition expenses, such as insurance, inventory, etc. The debtor will often be permitted to continue to use pre-petition financial statements that may require some deciphering. The creditor may want to review the reports to determine the salaries of the officers and other information. The reports may demonstrate that the debtor is continuing to lose money.

Authority to Operate Business

The debtor in possession's broad authority to conduct business includes ordinary course of business asset sales without specific court order. Thus, if the debtor is in the business of manufacturing and selling widgets, the debtor will normally continue to manufacture and sell widgets just as it did before the bankruptcy case was filed and the automatic stay went into effect. Only if the debtor intends to sell assets outside the ordinary course of business is specific notice to creditors and possible court approval required.

For example, if the debtor, a widget manufacturer, intended to sell most of its manufacturing equipment or its real estate, it would have to apply to the court for approval and give notice to creditors of the proposed sale because such a sale would not ordinarily be part of its business. The creditor may assume that absent a request for intervention by the creditors, the creditors' committee or the stockholders, the debtor will continue in operation of its business subject to the general supervision of the court and overview by the United States Trustee and the creditors' committee (if one exists).

As will be discussed in greater detail to follow, in Chapter 11 cases the debtor is given the exclusive right to file a plan of reorganization for a specified period of time, which can be extended only by court order (*see* Plan of Reorganization below). While its power may be restricted or modified by court order, the debtor, at least initially, remains in possession of the business, operates it in the ordinary course of that particular type of business and initially has the exclusive right to propose a plan of reorganization.

Debtors in possession will seek unsecured trade credit during the Chapter 11 proceeding from the debtor's vendors. Oftentimes, these vendors will be told that "the court guaranteed the debt" or "it is a number one priority" in payment. The court does not guarantee any debt. An obligation of the debtor in possession is a higher priority administrative claim, which is still an unsecured obligation. If the secured debts are greater than the value of the assets securing them, or if the estate is administratively insolvent (the administrative debts are more than the assets), administrative expense creditors will not be paid in full. Creditors should consider a debtor in possession a new customer, and consider the extension of trade credit as they would with any new customer. In any event, creditors should proceed very carefully on their post-petition credit decisions and not compound their loss in the bankruptcy case.

Trade creditors doing business with a Chapter 11 debtor, whose secured lender has a blanket floating security interest in the debtor's accounts and inventory, should also make sure the debtor has received bankruptcy court approval of an order authorizing either financing or the debtor's use of the lender's cash collateral. The United States Court of Appeals for the Eleventh Circuit, in *In re Delco Oil Inc.*, has held that a trustee could recover a debtor's post-petition payments to a trade creditor,

for goods sold to the debtor during a Chapter 11 case, because the debtor had made unauthorized cash payments to the trade creditor. The court relied on Sections 549(a) and 550(a) of the Bankruptcy Code that allows a trustee to avoid and recover a debtor's unauthorized transfers of property of the estate, and Section 363(c)(2) of the Bankruptcy Code that prohibits a debtor from using the cash proceeds of a secured lender's collateral without the lender's consent or bankruptcy court approval. In *Delco Oil Inc.*, the Eleventh Circuit concluded that the debtor had made unauthorized post-petition cash in advance payments to a trade creditor that the trustee could avoid and recover because the debtor's pre-petition secured lender had not consented to the debtor's use of cash collateral and the bankruptcy court had not approved the debtor's motion for use of the lender's cash collateral. It did not matter that the creditor's post-petition sales to the debtor were ordinary course transactions, the creditor had lacked knowledge that the debtor's payments were subject to challenge, and the lender was not harmed by the debtor's unauthorized payments because the creditor had provided goods of equivalent value to the debtor.

Creditors' Committee

FORMATION OF THE CREDITORS' COMMITTEE

Under Chapter 11, the United States Trustee is required to attempt to appoint a creditors' committee of unsecured creditors willing to serve. The well-known presumption in favor of the seven largest unsecured creditors being appointed to the creditors' committee no longer holds true in every case. (11 U.S.C. §1102(b)(1)). Creditors willing to serve do not necessarily hold the largest claims, and sometimes an active creditors' network exists that results in the formation of a creditors' committee even before a bankruptcy is filed. The Bankruptcy Code specifically authorizes the United States Trustee to approve and appoint a pre-petition committee if it is appropriately representative. Creditors' committees are appointed in fewer cases simply because creditors are unwilling to serve. However, as a result of BAPCPA's changes, discussed below, a small business creditor can be appointed to a creditors' committee if the creditor holds a claim, the aggregate of which is disproportionately large in comparison to the annual gross income of that creditor.

In most instances, the United States Trustee will contact the largest unsecured creditors from the list filed with the Chapter 11 petition and invite them to join a committee. In many large cases, the United States Trustee is now notifying the 30 to 50 largest unsecured creditors to ascertain their interest in serving on a creditors' committee. If a creditor holding a large claim is interested in appointment to the committee, the creditor should contact the United States Trustee supervising the case. Also the creditor should return any solicitation form sent by the United States Trustee in order to be considered for membership on the committee.

The United States Trustee will normally file a formal pleading with the court stating the names and addresses of the particular creditors appointed to serve on the committee.

COMMITTEE'S FIDUCIARY DUTY

If the creditor is considering potential membership in the creditors' committee, it should be remembered that the committee has a fiduciary duty to represent all creditors rather than the specific interest of the individual creditor appointed to the committee. Generally, the committee must act through its members and all members must act in a fashion that is in the best interest of all creditors and not in the interest of a specific creditor or a small group of creditors.

CONSIDERATIONS FOR MEMBERS

Membership on the committee not only gives the creditor an opportunity to help shape the direction of the case and have input on what a plan of reorganization may provide, it is also a good way to gather information about the debtor. The committee will generally be provided with reports concerning the debtor's operation as they are filed with the United States Trustee as well as reports from the committee's professionals.

Committee Governance

Just how the committee calls and controls its meetings, votes on issues presented and otherwise governs its actions is not the subject of any statutory provision or rule. Most committees meet on an ad hoc basis when everyone is available and take action by a majority vote. Committees also routinely conduct their meetings by telephone. Some committees have elaborate bylaws governing the calling of meetings, quorum, expenses, etc. While elaborate bylaws may be appropriate in a large case, they may hinder the quick action necessary in some of the smaller cases. The creditor should decide on a case-by-case basis what rules, if any, are appropriate.

Employment of Professionals

The Bankruptcy Code specifically allows official creditors' committees to retain counsel, accountants and other professionals at the expense of the estate. (11 U.S.C. §1103(a)). Note, however, that the professional fees are an administrative expense and are paid before any distribution is made to lower priority and general unsecured creditors. Generally, the committee will vote to retain a particular attorney, accountant or other professional and will submit an application to the court for approval of the employment of the professional. The application must have been submitted and approved by the court before the professional can be paid any compensation from the bankruptcy estate. (11 U.S.C. §§327, 328). Generally, individual members of the committee are not liable for the fees of professionals unless they separately contract with the individual professional. Thus, simply being on the creditors' committee does not obligate a creditor to pay the committee's professional fees. The creditor may, however, agree to guarantee payment of those fees.

Committee's Relationship with the Debtor in Possession

The committee's relationship with the debtor in possession is often a complicated one since there are no specific statutory or regulatory guidelines defining the role of the committee in the day-to-day operations of the business. (11 U.S.C. §1103(c)). For the most part the relationship will depend upon the size and complexity of the case and the knowledge of both the officers of the debtor and the members of the committee. The committee's involvement may range from objecting to salaries paid to insiders, to active pursuit of preferential and fraudulent transfers on behalf of all creditors, to the filing of a plan. Certainly, the committee should be involved in negotiations on any proposed plan of reorganization.

In some respects the committee's relationship to the debtor is similar to that of an advisory board of directors that cannot directly instruct the debtor or the debtor's officers to take action in the operation of the business, but it may make suggestions and, if those suggestions are not considered, may bring the issue before the court for ruling. However, normally the court will not substitute its business judgment for that of the debtor's officers. At least in theory, the existing board of the debtor in possession continues to govern the actions of the debtor provided those actions are in the best interests of all creditors. The situation is more difficult with a sole proprietorship or closely controlled corporation. There the officers may also be the shareholders and directors of the corporation or the sole proprietor of the business, and their individual interests may actually conflict with those of the creditors. Even in a large reorganization the officers often seem more interested in preserving their salaries and perks than paying creditors.

Generally, a committee's chief weapon will be its ability to object to motions for which the debtor seeks court approval and recommend or oppose confirmation of a proposed plan of reorganization. Creditors will be much more willing to accept and approve a plan of reorganization that is supported by the creditors' committee. Likewise, a plan that has been rejected by the committee and against which the committee actively campaigns is more likely to fail. (*See below* for a discussion of potential plans and the voting process.)

PURSUIT OF TRANSFERS

Often, the committee will find itself in the position of pursuing, subject to court approval, fraudulent or preferential transfer actions. For a variety of reasons the debtor may refuse to pursue fraudulent or preferential transfer actions against essential suppliers, insiders, family members or other individuals or entities that are closely related to the debtor. The pursuit of a preferential or fraudulent transfer may also be used as a negotiating tactic to offset a claim asserted against the debtor.

AVOIDANCE ACTIONS

Equally as frequent, the committee may ask the court for authority to pursue an avoidance action against a secured creditor whose secured claim did not attach to a particular category of assets and/or is not properly perfected. Particularly in the tumultuous period leading to the filing of the bankruptcy petition, creditors often do not properly perfect their security interests or discover that their security interest lapsed or they did not have a valid security interest in certain or all of a debtor's assets. In that case the debtor may have good reason for not wanting to pursue the avoidance action, particularly if the secured creditor is holding a personal guaranty. The committee may bring the action to either create assets for the unsecured estate or as a negotiating tactic in the formulation of a plan.

NEGOTIATIONS ON THE PLAN OF REORGANIZATION

Perhaps the primary role that a creditors' committee can play in any Chapter 11 case proceeding is providing input in negotiations toward the formulation of a plan of reorganization. In the negotiation process, the committee's primary weapon is its ability to object to the plan proposed by the debtor and to oppose confirmation of the plan, both through the solicitation of votes against the plan and litigation of the confirmability of the plan after the solicitation of votes. (*See below*.)

COMMITTEE INTERACTION WITH TRUSTEE

The committee, as well as other parties in interest, may seek the appointment of an examiner or a trustee in any case, which must be approved by the bankruptcy court. The United States Trustee appoints an interim trustee, after consultation with the parties upon order of the court. If a party in interest so requests within 30 days of the entry of the court order directing appointment of a trustee, the United States Trustee must convene a meeting of creditors for the purpose of electing a trustee in the case (except in a railroad proceeding). This provision will give creditors considerable leverage in selection of the trustee. The request for an election should be in writing and filed as a pleading with the court and served by mail on the interim trustee, the United States Trustee and such other parties in interest as the court may order. The United States Trustee will then pick a date for the meeting of creditors. It is not clear whether the United States Trustee or the party requesting the election will be required to give notice of the meeting. At the meeting, the election will be conducted according to 11 U.S.C. §702, which requires that creditors holding at least 20 percent in amount of the undisputed, liquidated and unsecured claims actually vote in the election. A candidate must be "disinterested"—that is, the potential trustee must not represent any party in interest and may not hold any interest adverse to the estate. If no trustee is elected under 11 U.S.C. §702, the interim trustee apparently continues in office.

CAVEAT: In many cases the prompt appointment and qualification of a trustee is critical to safeguarding the assets. Since an election demand might slow down the process, creditors should carefully consider the effect of making a demand.

Once the trustee is appointed, the committee's relationship with the debtor and role in the case may change significantly. The debtor is no longer the debtor in possession, but has been supplanted by the trustee. The trustee becomes the overall manager of the business even though the trustee may not personally operate the business on a day-to-day basis. The trustee can control the hiring and firing of staff to operate the business, effect changes in the business operation itself, and continue to operate the business absent a court order limiting the trustee's authority. Although many parties consider the appointment of a trustee as a sure sign that the bankruptcy is headed for liquidation, the appointment of a trustee may be the only way to get control of certain expenses and sales of assets for the benefit of all creditors. Once selected, the trustee becomes a fiduciary for all creditors and must consider the

interests of all creditors and other parties in interest, whether secured, unsecured or otherwise. While a trustee will generally act as a caretaker to conserve the business assets pending the proposal and confirmation of a plan, a trustee may propose a plan and submit it to creditors.

BAPCPA Changes Concerning Committees

Section 1102(a) of the Bankruptcy Code, as modified by BAPCPA, has increased the bankruptcy court's powers relative to committees. The court has the power to determine any disputes with respect to membership on a committee. At the request of an interested party or parties, and after notice and a hearing, the bankruptcy court can direct the United States Trustee to add a creditor to the committee or otherwise change the size or composition of the committee to ensure adequate representation of creditors.

The change also specifically allows the United States Trustee to add a small business concern to a creditors' committee if the court determines that the small business' claim is of the kind represented by the committee and is disproportionately large when compared to the creditor's annual gross revenue. A "small business concern" is defined as "independently owned and operated" and "not dominant in its field of operation." (15 U.S.C. 9632(a)—Small Business Act). This is designed to enable small businesses to play a larger role in Chapter 11 cases, in contrast to pre-BAPCPA Chapter 11 cases where most small businesses frequently had claims too small to be eligible to serve on a committee. If a creditor is a small business and wishes to serve on a creditors' committee, the creditor should write to the United States Trustee and request appointment. Otherwise, the only recourse is to move for a court order directing an appointment to the committee, which may be too expensive to pursue as it requires retaining counsel to move for this relief.

In addition, the creditors' committee must provide creditors, who hold claims of the kind represented by that committee and who are not appointed to the committee, access to information about the debtor in the committee's possession. A disgruntled creditor who does not obtain information requested from the committee can also obtain a court order directing the committee to provide the information. This raises confidentiality issues since the committee usually holds nonpublic information about the debtor and its business. The committee is foisted into the middle between a debtor who would be reluctant to provide nonpublic information because of the risk that a non-member creditor will force its disclosure, and the creditor seeking the information.

The committee is also required to solicit and receive comments from those creditors holding claims of the kind represented by that committee and who are not committee members.

The statute is silent about what information a committee must provide to non-member creditors whose interests the committee represents. The action a committee must take to solicit comments from creditors is also unclear. Frequently, the courts have approved protocols to provide public non-confidential information about the debtor to, and solicit comments from, creditors that are not members of the committee. These protocols provide for any one or more of the following: (1) granting creditors access to non-confidential public information; (2) requiring or permitting the establishment of a committee website to provide such information; (3) distributing case updates; (4) granting access for answering creditor inquiries and soliciting comments; (5) precluding the committee's disclosure of confidential, privileged and other nonpublic information, without prior court approval; (6) conditioning the committee's release of confidential information upon the creditors' execution of a confidentiality agreement and providing notice to, and the opportunity to object to the release by, the provider of the confidential information; and/or (7) protecting from liability the committee and its members and professionals that comply with the protocol. Creditors should also check the Local Rules adopted by the various bankruptcy courts. Local Massachusetts Bankruptcy Rule 2003-1, for Massachusetts bankruptcy cases, has adopted procedures a committee must follow to satisfy the information disclosure and solicitation of comment requirements.

KEY PROBLEMS IN REORGANIZATION

Overview

The Bankruptcy Code also affords creditors the right to notice on many actions affecting the operation of the business and the assets of the bankruptcy estate. In particular, unsecured creditors are entitled to notice, at least through a committee, of many actions that may have the effect of diminishing the assets available for the unsecured creditors. Thus, while the bankruptcy petition in one respect bars the immediate dismemberment of the debtor, it creates a number of problems for all of the parties that must be dealt with almost immediately. They range from the use of cash and assets subject to existing security interests to the assumption and rejection of existing leases and contracts. This section will deal briefly with some of the key post-petition problems and some of the practical and legal problems inherent in dealing with them. As always, this list is not exhaustive. Virtually every case has its unique aspects and it is impossible to enumerate all of the problems that will be encountered immediately after the filing of the bankruptcy petition.

Cash Collateral

Just as the Bankruptcy Code's automatic stay prohibits the creditor from seizing its collateral through judicial or other action, the Code also limits the extent to which a debtor can use "cash collateral," or cash generated through the sale of inventory or the collection of receivables subject to a pre-petition lien. Cash collateral encompasses any cash assets in the hands of the debtor at the time of the petition that are subject to a valid and properly perfected security interest. (11 U.S.C. §363(a)). Included in the definition of security interest for these purposes is the right to offset a bank account against any obligations of the debtor. While accounts receivable and funds generated from the sale of assets or services by the debtor are the most common examples, virtually any cash that is the identifiable proceeds of a pre-petition asset subject to a valid security interest is subject to the rules on cash collateral. If the accounts receivable or inventory, or both, are subject to valid pre-petition security interests, the debtor may not use those cash proceeds without: (1) the express permission of the creditor holding the security interest; or (2) a court order allowing the use. (11 U.S.C. §363(c)(2)). Cash collateral may include rent and payment for lodging. The court order allowing the use of cash collateral may not be entered unless the creditor is afforded "adequate protection" for the use of its collateral. Generally, of course, the creditor will be granted a security interest in the replacement inventory purchased with its cash collateral.

Procedurally, before the debtor and the secured lender can enter into an agreement for the use of cash collateral, the debtor must give notice to all parties in interest of the proposed agreement and its terms and conditions. (11 U.S.C. §363, Fed. R. Bankr. P. 2002, 4001). Moreover, no *final* order can be entered earlier than 15 days after the service of a motion for use of cash collateral. This prevents a debtor and creditor from tying up the estate without notice the day the petition is filed. Quite often, filing results in a frantic scramble to round up cash to pay salaries, payroll, utilities and key suppliers, among other things. The Bankruptcy Code requires that the debtor give notice either to the creditors' committee, if one has properly been formed, or to the 20 largest unsecured creditors as well as any other parties claiming a security interest in the receivables and inventory from which the cash collateral was generated, anyone claiming a lien on the real estate generating cash, the United States Trustee, the IRS and several other government agencies. (Fed. R. Bankr. P. 4001). Failure to give the proper notice to the largest unsecured creditors prior to approval of an agreement between the debtor and a secured creditor concerning the use of cash allows the court to subsequently set aside the agreement and avoid any liens created in the agreement. The court may, on an emergency basis, allow the debtor to use receivables, inventory and other cash collateral proceeds for the minimum necessary operating expenses for the first 15 days of the case. However, until the court holds a final hearing, it likely will not enter a final cash collateral order approving the debtor's agreement with the secured creditor as to the validity of its security interest and the granting of a lien on the unencumbered assets. The final hearing may not take place less than 15 days after the notice is given. This will give a creditor or a committee an opportunity to review not only the bank's documentation for defects, but also give the committee a chance to hire counsel and make the necessary objections.

Post-Petition Credit

Post-petition credit is one of the major problems in any reorganization case. While the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure require that any post-petition *secured* credit obtained have court approval before it can become effective, certain types of unsecured post-petition credit (such as trade credit) do not require notice or court approval. (11 U.S.C. §364, Fed. R. Bankr. P. 4001).

Beyond requiring that the parties give notice and an opportunity to object to the proposed post-petition credit (whether secured or unsecured) that require court approval, the court does not regulate in any detail the terms under which credit can be obtained to continue the operation of the debtor in possession. Generally speaking, the notice of any post-petition credit requested by the debtor must contain a summary of the terms, the amount of the credit and the proposed creditor. More often than not a pre-petition secured creditor will extend post-petition secured credit to keep the debtor afloat to preserve the value of its inventory and receivables collateral. The difficulty is that the post-petition credit may come at the expense of the unsecured creditors if the post-petition credit is secured by a lien on the remaining unencumbered assets of the debtor. Thus, as an unsecured creditor, the creditor should be sure to examine and, if necessary, oppose any proposed post-petition secured credit. At the same time, if a creditor continues to sell inventory or services to the debtor on a post-petition basis, the creditor should understand its rights against the estate in the event of liquidation.

Assumption or Rejection of Executory Contracts and Leases

One of the more complicated issues in any major bankruptcy case will involve the assumption or rejection of executory contracts and unexpired leases under 11 U.S.C. §365. This enables a trustee or debtor in possession to take advantage of favorable executory contracts and leases and shed burdensome and unprofitable agreements. This section permits the debtor, with court approval, to "assume or reject" an executory contract or an unexpired lease.

The Bankruptcy Code does not define an executory contract. An executory contract has been defined by the courts to include contracts on which performance remains due to some extent on both sides. An alternative definition includes contracts under which the obligations of other parties are so unperformed that the failure of either party to complete performance would constitute a mutual breach excusing the other from performance.

As a general rule, in Chapter 11 cases, Section 365 does not contain any deadline for assumption or rejection of executory contracts or personal property leases. However, Section 365 contains a deadline with respect to nonresidential real property (i.e., commercial) leases under which the debtor is a tenant. In the event the debtor fails to assume a nonresidential real property lease prior to the deadline, the lease is deemed rejected. Any claim arising from the rejection of the lease is limited to the greater of one year's rent or 15 percent of the remaining lease price. (11 U.S.C. §502(b)(6)).

The importance of this rather esoteric area in the bankruptcy law is that the timely assumption of the lease may generate a valuable asset since the debtor may sublease or sell the lease tenancy to a purchaser who can take advantage of the favorable rates provided in the lease with the debtor. Moreover, if the debtor is a retailing business with multiple locations and is seeking to cut back and restructure the business on a smaller scale, the ability to reject unexpired leases on store locations may be essential. Likewise, however, if the restructuring includes closing stores which are leased at a favorable rate, the debtor may be able to generate cash for unsecured creditors or for continued operations by assuming the lease and assigning it to a purchaser.

BAPCPA modified Section 365(d)(4) to provide that a debtor must assume or reject an unexpired lease of nonresidential real property by the earlier of: (1) 120 days from the date of the commencement of the bankruptcy case; and (2) the date of confirmation of a plan. The debtor's failure to assume or reject a lease by such date will result in the lease being deemed rejected. A court may extend the 120-day deadline for up to one additional 90-day period, upon motion of the debtor, for cause shown, which is generally satisfied. This extension must be granted prior to the expiration of the original 120-day period. The court may only grant subsequent extensions upon the prior written consent of the lessor for each such extension.

The bankruptcy court no longer has the authority to grant extensions of time to assume or reject a nonresidential real property lease outside the 210-day period absent the lessor's written agreement. This will greatly expand a lessor's ability to force a debtor to decide early in a case whether to assume or reject commercial leases by denying the court any discretion to extend the debtor's time to assume or reject the lease after the maximum 210-day period, without the lessor's written consent. This could make it far more difficult for a debtor, particularly a retail debtor, to reorganize, forcing the debtor to make a premature decision to either: (1) assume burdensome leases, that would require the debtor to pay unpaid pre-petition rent charges, and, if later rejected, could saddle the estate with substantial administrative debt; or (2) reject valuable leases.

A new Section 503(b)(7) caps the landlord's administrative expense claim related to a nonresidential real property lease that is assumed under Section 365 and subsequently rejected. The amount of the allowed administrative claim arising from the debtor's rejection of a previously assumed nonresidential real property lease is equal to all monetary obligations due (excluding those relating to failure to operate or a penalty provision) for a period of two years following the later of: (1) the date of rejection of the lease; or (2) the date of actual turnover of the premises. This administrative claim cannot be subject to reduction or set-off for any reason, except for amounts actually received or to be received from a nondebtor entity. The lessor's claim for the balance of rejection damages beyond this two-year period will be treated as a general unsecured claim subject to the cap contained in Section 502(b)(6).

Also under new Section 365(p), when a personal property lease is rejected or not timely assumed, the leased property is no longer property of the estate and no longer subject to the automatic stay. This change enables a personal property lessor to repossess the leased equipment without the necessity for obtaining a court order lifting the automatic stay.

Expanded Rights for Utilities

Section 366 of the Bankruptcy Code affords utility providers significant protections. A utility will be permitted to alter, refuse or discontinue service, after 20 or 30 days (there is an inconsistency in Section 366) from the commencement of a Chapter 11 bankruptcy case if the utility does not receive adequate assurance of payment. Section 366 requires a debtor to provide its utilities "assurance of payment" of their post-petition charges in exchange for the utilities' continued service. "Assurance of payment" requires: (1) a cash deposit; (2) a letter of credit; (3) a certificate of deposit; (4) a surety bond; (5) a prepayment of utility consumption; or (6) another form of security agreed to by the utility and the debtor. An administrative expense claim does not constitute adequate assurance of payment.

The court may order modification of the amount of the cash deposit or other assurance of payment to a debtor's utilities. In making a determination of the adequacy of such payment, the court may not consider: (1) the absence of security before the commencement of the bankruptcy case; (2) the debtor's timely payments to the utility prior to the commencement of the bankruptcy case; or (3) the availability of an administrative expense priority.

Section 366 also allows a utility to recover or set-off any security deposit held by the utility prior to the commencement of the debtor's Chapter 11 case, against the utility's pre-petition claim against the debtor, without notice or order of the court.

Conversion/Dismissal of a Chapter 11 Case

BAPCPA modified Section 1112(b) by expanding the grounds that a court can rely upon to dismiss a Chapter 11 case or convert a Chapter 11 case to a case under Chapter 7. A court is required to convert or dismiss a case (whichever is in the best interest of the estate) if a movant establishes "cause." Section 1112(b) provides a non-exhaustive list of 16 factors that may be a basis for finding "cause." These are:

(1) substantial or continuing loss to, or diminution of, the estate and the absence of a reasonable likelihood of rehabilitation;

(2) gross mismanagement of the estate;

(3) failure to maintain appropriate insurance that poses a risk to the estate or to the public;
(4) unauthorized use of cash collateral substantially harmful to one or more creditors;
(5) failure to comply with an order of the court;
(6) unexcused failure to timely satisfy any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter;
(7) failure to attend the meeting of creditors convened under Section 341(a) or an examination ordered under Rule 2004 of the Federal Rules of Bankruptcy Procedure without good cause shown by the debtor;
(8) failure to timely provide information or attend meetings reasonably requested by the United States Trustee (or the bankruptcy administrator, if any);
(9) failure to timely pay taxes owed after the commencement of the bankruptcy or to file tax returns due thereafter;
(10) failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by the Bankruptcy Code or by order of the court;
(11) failure to pay any fees or charges required under Chapter 123 of Title 28;
(12) revocation of an order of confirmation under Section 1144 of the Bankruptcy Code;
(13) inability to effectuate substantial consummation of a confirmed plan;
(14) material default by the debtor with respect to a confirmed plan;
(15) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and
(16) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the bankruptcy case.

If the movant does establish cause, the court may only deny a motion to convert or dismiss the case if the debtor, or another party in interest, objects and establishes: (1) there is a reasonable likelihood that a plan will be confirmed within applicable timeframes; (2) the grounds for granting the relief include an act or omission for which there exists a reasonable justification; and (3) such act or omission will be cured in a reasonable time, and the court identifies unusual circumstances (not defined in the statute) showing that conversion or dismissal is not in the best interests of creditors and the estate. However, where the grounds of "cause" are the substantial and continuing loss or diminution of the estate and the absence of a reasonable likelihood of rehabilitation, the court cannot deny dismissal or conversion. This is a far more difficult burden of proof for debtors to satisfy to overcome a conversion/dismissal motion.

Section 1112 also expedites the disposition of conversion/dismissal motions. It requires the court to commence a hearing on a motion to convert or dismiss a Chapter 11 case not later than 30 days after the date the motion is filed. The court must decide the motion within 15 days after the commencement of the hearing. However, the court could delay the hearing and ruling if: (1) the movant expressly consents to the continuance for a specific time; or (2) compelling circumstances (not defined in the statute) prevent the court from meeting these time requirements.

Motions for a Trustee or Examiner

Preliminary Comment

As a general rule, the debtor remains in possession and operates the debtor's business under Chapter 11. The Code provides, however, for the appointment (and, in some cases, the election) of a trustee or an examiner for cause pursuant to 11 U.S.C. §1104.

Appointment of a Trustee or Examiner

Under 11 U.S.C. §1104, cause is broadly defined as including (but is not limited to) pre- or post-petition fraud by management, dishonesty or gross mismanagement. The basis for appointment of a trustee had been the subject of a great deal of case law, and it is difficult to set out a single, clear rule. If the creditor believes that "cause" exists for appointment of a trustee, the creditor should consult

counsel early in the case. An examiner may be appointed for similar reasons, but generally will not operate a business.

BAPCPA has modified Section 1104(a) to include additional grounds for a court to direct the United States Trustee to appoint a Chapter 11 trustee. The court could order appointment if grounds exist to convert or dismiss the Chapter 11 case under Section 1112, and the court determines that the appointment of a trustee is in the best interests of creditors and the estate.

The United States Trustee must move for the appointment of a Chapter 11 trustee if there are reasonable grounds to suspect that: (1) current members of the debtor's governing body; (2) the debtor's CEO or CFO; or (3) the members of the governing body who selected the debtor's CEO or CFO participated in actual fraud, dishonesty or criminal conduct in the management of the debtor or the debtor's public financial reporting. This requirement was in response to cases like Enron, WorldCom and Adelphia, where allegations of fraud by pre-petition management were raised.

Section 1104 also requires that the United States Trustee file a report certifying the election of a Chapter 11 trustee at a meeting of creditors. The newly elected trustee is deemed appointed, and any interim trustee's appointment is deemed terminated, upon such filing. The bankruptcy court resolves any election disputes.

Note that creditors may request that the United States Trustee convene a meeting of creditors for the purpose of electing a disinterested person trustee. There is no provision for electing an examiner. A creditor desiring an election must file a written request for one within 30 days of the entry of an order directing the appointment of a trustee. Thereafter, the United States Trustee must convene a meeting of creditors and conduct the election. If creditors holding at least 20 percent in amount of the fixed, liquidated, undisputed, unsecured claims in the case vote, the disinterested nominee receiving a majority of the votes in the election becomes the trustee. Presumably, in those cases where the creditors holding the necessary minimum amount do not vote, the appointed trustee remains trustee.

TRUSTEES' DUTIES AND POWERS

A trustee has all of the powers of a Chapter 7 trustee and, in addition, may continue to operate the business if, in the trustee's judgment, the business should be operated. In effect, the trustee becomes like a new board of directors in a large case, directing management in the continued operation of the business. In a smaller case the trustee may actually take over the business and run it personally. Generally that is not practical, however, since the trustee may lack the time or the specific experience necessary to run the debtor's business. The trustee is a fiduciary who acts for the benefit of all creditors in a case, whether secured or unsecured, and must also consider the interest of equity security interest holders. A Chapter 11 trustee may employ counsel, accountants and other professionals, and take virtually any action necessary to preserve and protect the assets of the estate and operate the business. The courts will rarely interfere with a trustee's business judgment on continued operation of the business or the sale of specific assets pending the reorganization plan. Occasionally, however, a court will limit a trustee's ability to sell certain assets pending the proposal of a plan of reorganization.

As will be discussed below in the section on plans, the appointment of a trustee terminates the debtor's exclusive right to propose a plan of reorganization and a trustee or any party in interest may, thereafter, propose a plan of reorganization.

THE EXAMINER

The Bankruptcy Code authorizes the court to direct the appointment of an examiner as an alternative to the appointment of a trustee where cause exists, the unsecured debts of the company exceed $5,000,000, or grounds for dismissal or conversion of the case exist and the appointment is in the best interest of the estate. Often, the court will direct the appointment of an examiner where it is not satisfied that the expense of a trustee is warranted, but feels the creditors are entitled to an objective analysis of the debtor's assets, operation, plan or estate claims.

In theory, an examiner is an objective reviewer of the financial and legal condition of the debtor. An examiner is required to make a report on the debtor's business or other matters for which the examiner is appointed, but may not operate the business or interfere in the operation of the business

by the debtor in possession. Anyone appointed as an examiner is barred from serving as a trustee in the case if the court later directs the appointment of a trustee. The process for appointment of an examiner is the same as that of a trustee: The court directs the appointment and the United States Trustee, after appropriate consultation with the parties, makes the appointment. There is, however, no provision for election of an examiner in any case.

In many cases an examiner is a less expensive alternative to the appointment of a trustee since an examiner does not operate the business and is not entitled to a fee based on distributions from the business while the examiner is in place. In practice, most examiners are attorneys, accountants or business people with experience in the industry in which the debtor operates. Generally, an examiner is compensated on an hourly basis based on time spent. An examiner may, with court approval, employ other professionals such as an attorney or an accountant.

Tactical Considerations

A creditor should not lightly seek the appointment of a trustee or examiner because of expense to the estate for both the litigation over the appointment and, if appointed, the trustee's or examiner's fees and expenses. The courts are not anxious to appoint trustees, particularly in the more complex and unusual cases. For example, a trustee can rarely be found to operate a farming operation, and it is, therefore, simply impractical to have the court order that the case proceed under the direction of a trustee.

A major drawback to the appointment of a trustee from an unsecured creditor's point of view is the trustee's compensation scheme. The fees requested are an administrative expense that are paid ahead of unsecured claims in the bankruptcy case.

Under the Bankruptcy Code, a trustee appointed by the United States Trustee in a Chapter 11 case is entitled to compensation based upon distributions to creditors in the bankruptcy case. In a major case, the trustee's fees can be substantial since they are assessed as a percentage of the gross expenditures of the estate. The maximum compensation is an upper limit on what the court may award. In some cases the courts will cut the requested compensation, based upon the amount of time the trustee actually had to spend on the case.

Before the trustee can be paid, the trustee must apply to the court and give notice to creditors of the intended request. The court may approve the request on an interim or on a final basis if no one objects.

PLANS OF REORGANIZATION

Overview

Given the ever-increasing number of Chapter 11 filings, an observer might assume that Chapter 11 is some sort of panacea for all the ills of debtors, large and small. Many large businesses have filed Chapter 11s to eliminate executory leases or union contracts. The fact still exists that few Chapter 11 cases actually result in confirmation of a Chapter 11 plan of reorganization; instead, the vast majority of cases have plans of liquidations, are converted to Chapter 7 or are dismissed.

There are very few reliable statistics on the percentage of cases in which a plan has actually been confirmed and the case passes out of the bankruptcy court while still in Chapter 11 mode. Based on recent available studies, between 25 and 30 percent of all Chapter 11 cases result in some sort of plan. The percentage, however, may vary from district to district, depending upon the attitude of the court toward the Chapter 11 process, the sophistication of the bankruptcy bar and financial conditions in the region. Statistics about plan confirmation, conversion to Chapter 7 and the like are not terribly helpful because they do not properly indicate whether Chapter 11 is a "success." For example, a confirmed plan that revests the owners who so mismanaged the business that bankruptcy became necessary may not be terribly good for creditors. Similarly, a liquidating Chapter 11, or conversion of a Chapter 11 case to Chapter 7, may not signify failure because liquidation may present the most viable opportunity for creditors to be paid. From a trade creditor's standpoint, the debate is purely academic because the ability to be paid stems from the statutory language of the Code itself, not from spirited debate over the value of Chapter 11.

The confirmation of a plan is the goal of the Chapter 11 process. Proposing and confirming a plan can be difficult and time consuming even in a relatively simple case. "Prepackaged" or "pre-negotiated" plans have been proposed in some cases in which some or all the parties have generally agreed on the terms and conditions of the plan, exchanged the necessary financial information and solicited acceptances from creditors prior to the petition for relief. A prepackaged plan works only if there has been complete and candid pre-petition disclosure in a genuine effort to work out the treatment of most claims. Prepackaged and pre-negotiated plans are an illustration that the bankruptcy process need not take the months or years that many debtors and creditors have come to expect. The bankruptcy process, in fact, works better if a plan is proposed early on and a genuine effort is made to consider the interests of all parties.

The Bankruptcy Code provides a very broad framework on what must be contained in a plan. The statutory requirements are sufficiently general that they fit all types of cases. At the heart of the statutory scheme is the requirement that a plan must classify claims and equity interests and provide for their treatment. A plan must also provide for its execution, which generally requires a detailed description of how the debtor will be liquidated or reorganized and specific provisions for treatment of claims. Generally, in implementing the plan, a proposal may provide for the retention or sale of property, the merger of the debtor or virtually any other effort at liquidation or reorganization necessary to conclude the case. Quite often, Chapter 11 cases are filed to either renegotiate or reinstate mortgages or other secured and unsecured debt instruments. If the requisite majority of creditors does not accept a plan, it may be crammed down. Cramdown is the process by which a plan is confirmed over the objections of impaired creditors or shareholders to the provisions of the plan. The process is neither simple nor as successful as debtors' attorneys would have creditors think. Unless the plan provides for full payment of all unsecured claims with interest over a relatively short period of time, cramdown is rarely possible over the objections of unsecured creditors.

Many debtors (or debtors' officers) seem to think that Chapter 11 permits them to force creditors to accept virtually any treatment so long as it is better than the treatment they would receive in liquidation. That simply is not the case. A creditor should study the cramdown provisions since cramdown will be the major threat in negotiating the terms of a plan. The Bankruptcy Code includes a number of terms that must be considered before understanding the provisions of the Code itself.

Unless the creditor chooses to propose a plan to other creditors in a particular case, a process that may be complicated by creditors' lack of access to strategic details of the debtor's business as may be necessary to propose a plan, the primary concern will be the terms and conditions of the plan proposed by the debtor. A creditor should avoid the temptation to reject the plan simply because it was proposed by the debtor. Also, the creditor should not focus any energies on the plan that they might propose if given the chance.

Potential Plan Proponents

DEBTOR'S EXCLUSIVE PERIOD

The debtor in possession is given the exclusive right to file a plan of reorganization for the first 120 days following the petition for relief. (11 U.S.C. §1121). During the exclusive period only the debtor in possession may file a reorganization plan and have it considered by creditors. The court may shorten or extend that period after notice to creditors. While theoretically another party could propose a plan during the exclusivity period, it could not be submitted to creditors. Once that exclusive period has expired or has been terminated by the court, or a trustee has been appointed, virtually any party in interest in the case may file a plan. The debtor's exclusive period may be extended by court order if an application for the extension is made within the exclusive period itself. Practice varies from one part of the country to another. Some courts will routinely allow the debtor an extension of time to file a plan if it appears that progress is being made in the case. Other courts might refuse to extend the exclusive period on the theory that it puts more pressure on the debtor to bring the case to a successful conclusion as quickly as possible. A creditor should review with counsel a specific court's recent rulings on the extension of the exclusive period.

The exclusive period terminates 120 days after the petition for relief is filed unless the court extends it, which is routinely what courts have granted. It may also be terminated by court order on

application of one of the parties in interest and it automatically terminates upon the appointment of a trustee. It is difficult to terminate the exclusive period early in the case. Generally, a showing that the debtor is not actively pursuing a Chapter 11 plan or has no reasonable likelihood of confirming a plan is necessary to terminate the exclusive period. Once the debtor's exclusive period has expired or has been terminated by the court, virtually *any* party in interest in the case can propose a plan. The debtor still retains the right to propose a Chapter 11 plan even though the debtor's exclusive period has expired, but the debtor may find itself with competing plans, each seeking creditor approval.

BAPCPA amended Section 1121(d) by setting absolute deadlines for the exclusive time periods afforded to the debtor to file and solicit acceptances of a Chapter 11 plan. A debtor's exclusive right to file a Chapter 11 plan cannot be extended more than 18 months following the commencement of the bankruptcy case; and its exclusive right to solicit acceptances of a Chapter 11 plan cannot be extended more than 20 months after filing. These deadlines cannot be further extended by the court.

Any exclusivity extensions beyond the original 120 days are not automatic. The court can extend those times only if:

(1) the debtor, after notice to parties in interest, demonstrates by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time;
(2) a new deadline is imposed at the time the extension is granted; and
(3) the order extending the time is signed before the existing deadline has expired.

Non-Debtor Potential Plan Proponents

Often, the failure to propose a plan is due to some conflict among the debtor's shareholders, partners or officers if the debtor is a partnership or a corporation. In this situation the courts have held that the corporate officers and board of directors may not propose a plan on behalf of the debtor. Shareholders are also parties in interest and, therefore, may propose a plan, but not on behalf of the debtor. Similarly, any partner in a partnership may propose a Chapter 11 plan. Remember, however, that in a limited partnership case setting, the confirmation of a plan proposed by the limited partners may have other substantial legal consequences for the limited partners.

A creditors' committee may propose a plan of reorganization and often does as a negotiating tactic to bring the debtor to the bargaining table. Often, the debtor's proposed plan is unrealistic or proposes to retain management with whom the creditors are unwilling to work.

An individual creditor may propose a Chapter 11 plan. Unless the creditor has a substantial claim or is seeking to acquire the debtor's assets through what is essentially a hostile takeover plan, the expense and effort necessary to propose a plan may not be worthwhile for the individual creditor. There is increasing interest on behalf of outsiders to use the Chapter 11 process as a method of acquiring either the debtor's assets or the debtor as an entity itself. Further, since the Bankruptcy Code does not specifically regulate the process for the acquisition of claims, if the potential plan proponent is not actually a creditor in the case, the proponent must acquire a claim to become a party in interest to propose a plan. This has led to further litigation over the circumstances over which a non-creditor may purchase claims in an effort to become a party in interest to propose a Chapter 11 plan. Note, however, that not all persons interested in acquiring claims are doing so in an effort to be in a position to propose a plan. In many of the larger cases that involve publicly traded debt instruments, a market has sprung up that permits the purchase and sale of those debt instruments of a corporate entity in a Chapter 11 case. There is also a market for the sale of trade claims.

Plan Contents: Claims Classification and Treatment of Claims

Overview

The heart of any Chapter 11 plan is the classification and treatment of claims and interests. One of the first steps will be determining what assets will be available in the event of liquidation, which will essentially set the floor for any plan payment to creditors, and what other assets might be recoverable for the benefit of unsecured creditors to create a pool of assets for potential distribution to creditors.

DEFINITION AND PRIORITIES OF CLAIMS

The statutory definition of the term "claim" in the Bankruptcy Code is broad, including either a right to payment or a right to some equitable remedy, such as injunctive relief in the event of a breach of contract. A claim need not have matured at the time of the Chapter 11 filing and it may be disputed or contingent.

Within the broad concept of claim, there are a number of categories. Creditors holding liens on assets of the estate are secured creditors. (11 U.S.C. §502). All other claims are unsecured. Undersecured claims, where the value of the collateral is less than the amount of the claim held by the creditor, are partially secured and partially unsecured. Unsecured creditors are further broken down into priority claims that are entitled to payment from any unencumbered assets of the estate ahead of general unsecured claims. Certain types of claims are afforded priority in the distribution of the assets of the debtor's estate under §507 of the Bankruptcy Code. Administrative expenses, including claims for goods delivered or services rendered to the debtor on an unsecured basis post-petition, have the first priority. These claims must be satisfied in full before distribution is made to any other lower priority creditor. Various other claims entitled to lower priority status (which must be paid in full before nonpriority unsecured creditors) include certain post-petition unsecured claims against an involuntary debtor; claims for wages, salaries, commissions, vacation, severance and sick leave pay earned within 180 days prior to the bankruptcy in an amount per employee not to exceed $12,850; contributions to an employee benefit plan in an amount per employee not to exceed $12,850 subject to a specified cap; certain claims of farmers for grain stored or fish delivered to a processing facility in an amount not to exceed $6,325 per claimant; certain consumer deposits in an amount not to exceed $2,850 per claimant; and tax claims. Priority claims that are limited in amount are usually indexed for inflation and will increase every three years. A creditor should consider both its status as secured or unsecured and its priority status in considering the treatment of its claims in any Chapter 11 plan.

CLASSIFICATION AND TREATMENT OF CLAIMS IN A PLAN

The heart of any plan of reorganization will be the classification of claims and the provisions for treatment for each class of claims. In the simplest possible case—with a single fully secured creditor, a number of trade creditors with no priority unsecured claims and a single stockholder—a liquidation plan might provide a class for a secured creditor, a class for the unsecured trade creditors and an interest class for the single stockholder. The plan will provide for liquidation of the assets, satisfaction of the secured claim from the proceeds of any collateral, and the distribution of the balance to the unsecured creditors. In the unlikely event that there is any surplus after the satisfaction of all unsecured claims, the balance will be distributed to the stockholder.

The voting requirements of the Code require that at least one impaired class accept the plan before the court can consider it for confirmation. This often leads to some amazing hairsplitting by counsel for a proponent of a plan in an effort to create an impaired class likely to vote for the plan.

SECURED CREDITORS

Classification

The classification of secured creditors in a reorganization case is straightforward. As a general rule, the courts require that each secured creditor be placed in a separate class. However, if several secured creditors have liens with equal priority against the same collateral, they may be placed in a single class. For example, assume that the debtor's real estate is subject to a first, a second and a third mortgage. Assume that the value of the collateral is less than the total of the first and second claims. The first mortgage would be placed in a class and treated as fully secured; the second mortgage would be placed in a separate class and treated as partially secured and partially unsecured; the third mortgage would be relegated to unsecured status to be treated with other unsecured claims. In the unlikely event that a number of creditors have separate claims all secured by the same assets with an equal priority, those creditors would be placed in a single class. In designating the classes, the proponent must consider the legal rights of the creditors and the value of their collateral.

Treatment of Secured Creditors

The potential treatment of secured creditors will depend upon the value of their collateral. If the value equals or exceeds the amount of the claim, the proponent of the plan may surrender the collateral in full satisfaction of the claim. In other cases the debtor will wish to retain the collateral and reamortize the debt. This may include an extension of the debt beyond the existing maturity date or a rewriting of the terms of the debt including interest rate. Reamortization of the debt is particularly attractive where the debtor originally agreed to a relatively short term with a substantial balloon obligation, which the debtor now cannot refinance because of the value of the collateral or the condition of the local economy. In many situations the debtor will then propose a plan that calls for retention of the collateral, preservation of the creditor's lien on the collateral, and reamortization of the balance due at a reduced interest rate. Of course, any change in the terms of the repayment impairs the claim and requires that the creditor accept the proposed treatment or that the court confirm the plan under the cramdown rules. Litigation often ensues over the interest rate and the term of the paydown.

Another alternative is for the debtor to cure the default in the existing mortgage, if the terms of the existing mortgage are at less than current market rate. Generally, the plan will provide for the debtor to retain the collateral and make contract payments on the existing mortgage according to its terms, and an additional payment to cure any default. Often, the creditor will object that the mortgage is at a rate that is below the current market rate or that the period the debtor proposes for the cure of the default is too long. While the cure and reinstatement of the mortgage is more often a feature of consumer reorganization under Chapter 13, it does occur in Chapter 11 where the debtor wants to retain collateral, particularly if it has equity, but has fallen behind on an otherwise favorable mortgage.

Yet another option is for the debtor to sell the collateral, use the proceeds in the reorganization effort, and provide the creditor with a lien on other assets. A variation of this treatment involves sale of part of the creditor's collateral with the creditor retaining a lien on the unsold assets, but not receiving the sale proceeds. The value of the remaining assets must exceed the amount of the creditor's claim so that it remains fully secured. Assume, for example, that the debtor owns real estate that is no longer essential for the reorganization effort, but needs cash to generate a payment to unsecured creditors. Creditors secured by the real estate that is to be sold may be offered a second lien on assets to be retained and periodic payments to amortize the outstanding obligation as a replacement for the lien on the real estate.

Obviously, from the secured creditor's point of view, it is less interested in payments over a period of time from an often-shaky reorganized debtor than it is in recovering the proceeds of its collateral. This, of course, can lead to some valuation and treatment battles, but the option exists to provide a secured creditor with a replacement lien and sell the property for the benefit of the estate.

Finally, of course, the plan may provide for an orderly liquidation of the creditor's collateral over a period of time, with the proceeds being used to pay part of the administrative expenses and to satisfy the claim of the secured creditor. This type of treatment has been quite common in real estate reorganizations where the market has slumped sharply. For example, assume that the debtor owns a number of undeveloped lots. The secured creditor and the estate generally might benefit from an orderly liquidation of the lots over a long period of time rather than suddenly dumping them on the market, which would have the effect of depressing the price. The plan may provide for the continued operation of the debtor with ongoing sales and certain sales proceeds used to pay the operating expenses of the debtor with the remaining net proceeds being paid to the creditor.

Another form of liquidation may simply provide for an auction sale to be conducted after the confirmation of the plan. The proceeds would be applied first to the sale expenses and then to the lien holder's claim. The debtor would distribute any surplus to, first, priority unsecured creditors, and then what's remaining to nonpriority unsecured creditors *pro rata*. The unsecured creditor's concern in these situations is the timing of the sale. While dumping a large quantity of personal property of a particular type or a large amount of real estate on a particular market at once might depress the price, the other problem is the cost of debtor's continued operation during the liquidation process.

Potential Objections to Classification or Treatment of Secured Creditors

The creditors' committee or an individual creditor may potentially object to the classification or treatment of a secured creditor if it adversely affects the payment to unsecured creditors. If the debtor's officers or insiders have guaranteed payment of a particular debt, they may be inclined to treat that creditor as fully secured even where the collateral is worth less than the debt. Likewise, they are less likely to use the debtor in possession's strong arm powers to avoid an improperly perfected security interest. Therefore, the first step in an unsecured creditor's review of a plan will be to review the validity of a purportedly secured creditor's security interest and raise any objections as to the validity, extent, etc., of that security interest. This will require legal assistance since the defects in any given security agreement or mortgage are not often readily apparent. The creditor should also be cognizant that an order approving financing or the debtor's use of cash collateral might set deadlines for asserting such claims.

Unsecured creditors may also want to review the interest rate offered secured creditors under the plan. The Bankruptcy Code generally mandates a market interest rate for reamortized debt. The contract interest rate, including any default interest rate, may be substantially higher than the market rate at the time of confirmation.

Unsecured Creditors

CLASSIFICATION OF UNSECURED CLAIMS

If the classification and treatment of creditors and claims is the heart of any plan of reorganization, the most important part from an unsecured creditor's point of view is the classification and treatment of unsecured claims. At least one impaired class of creditors (determined without counting the votes of insiders) must accept a plan before it is eligible for confirmation under the cramdown rules of 11 U.S.C. §1129(b). A proponent must design one class of impaired claimants that is likely to accept the plan. This often leads to some interesting attempts at gerrymandering to ensure that one hostile creditor (generally the unsecured deficiency claim of a major undersecured creditor) is lumped together with friendly trade creditors in such a fashion that trade creditors' votes control the class and accept the plan. Conversely, the debtor may occasionally propose a plan that separates the trade creditors from the unsecured deficiency claim in an effort to generate the necessary accepting impaired class.

The rules for classification of unsecured creditors are always evolving. The Bankruptcy Code specifically mandates that all claims of a similar nature in a single class be given the same treatment. The courts have struggled with classification of claims and there appear to be three general theories that have evolved to this point including: (1) the single class theory; (2) the factual basis for classification theory; and (3) the administrative ease class theory. As a general rule, courts will approve any plan that places all unsecured creditors in a single class. Some courts have approved a classification of unsecured creditors in different classes so long as there is a rational legal or factual basis for the distinction.

From a practical point of view, the lumping of all unsecured creditors into a single large class can create substantial problems for the plan proponent at the confirmation stage. Acceptance requires that at least one-half in number and two-thirds in amount of the claims in that class that vote to actually accept the plan. Thus, a holder of a single large claim equaling or exceeding one-third of the claims *voting* on the plan may veto the plan even if all other creditors in that class accept. In a small- to medium-size case, this may give the holder of a large deficiency claim considerable leverage in negotiating the plan. In other situations, it may give veto power to the holders of a large number of small claims. Since more than one-half in number (and two-thirds in dollar amount) of the claims voting in the class must accept, the single large claim can block the plan, but cannot force other claimholders to accept. For example, assume that the debtor owes the bank $500,000 secured by a lien on property having a value of $400,000. The bank holds a $400,000 secured claim and an unsecured deficiency claim in the amount of $100,000. The debtor proposes a plan of reorganization that provides for payment of 10 cents on the dollar to unsecured creditors and the reamortization of the secured claim over a 30-year period at 6 percent interest. The debtor also owes trade creditors $200,000. Approximately 30 creditors hold the trade debt. The plan is put to a vote and the bank

votes its entire $100,000 deficiency against the plan. Twenty of the unsecured trade creditors holding claims totaling $150,000 vote in favor of the plan. While the plan may be confirmable under certain limited circumstances under the cramdown rules, the unsecured class proposed here has not accepted the plan since the bank voted $100,000 of its claim against the plan. The $100,000 is more than one-third of the $250,000 actually voting on the plan.

Conversely, if only the bank had voted for the plan, but 20 of the unsecured creditors voted *against* it, irrespective of the total of unsecured claims voting against the plan, only one creditor voted for the plan and 20 creditors voted against the plan; therefore, the class is deemed to have rejected the plan. Again, while there may be an avenue for confirmation under 11 U.S.C. §1129(b), the class itself has rejected the plan under these circumstances.

A number of courts have, however, approved plans with separate classification of groups of unsecured creditors based upon their relationship to the debtor or some other factual basis that relates to the operation of the case. In some respects the separate classification rules have developed from the Chapter 13 case law. Under Chapter 13 the courts have generally approved separate classification and treatment of creditors essential to the individual debtor's continued well-being and worth. For example, Chapter 13 cases fairly routinely approve a separate class for physicians or other health care providers treating the debtor post-petition. The theory is that if the unpaid doctor refuses to provide treatment, the debtor will be unable to continue to work and make payments under the plan. Some courts have, likewise, allowed separate Chapter 11 treatment for trade creditors who will continue to do business with the debtor on a post-petition basis.

For example, if manufacturer Y supplies an essential subassembly or raw material for the debtor's products, manufacturer Y's pre-petition claim might be placed in a separate class since without their assent and continued delivery of the essential products, the debtor's reorganization will not succeed. The courts have also approved separate classification and treatment for priority claimants such as employee claims and tax claims. The case law in this area is still evolving, and each case will have to be separately considered. If a creditor is dealing with a plan that classifies unsecured creditors into multiple classes with separate and more favorable treatment for some classes than others, they should consider an objection to the classification of creditors. Normally, the objection will have to be timely filed before the confirmation hearing at the latest.

Conversely, if a creditor is dealing with a large group of creditors holding different types of unsecured claims and wishes to propose a plan, the creditor should try to come up with a factual basis for splitting the unsecured claims into different classes for treatment and voting purposes. Most courts accept such separate treatment if there is a factual basis for the separate classification.

Finally, the Code specifically permits the proponent of a plan to propose an administrative class of small claims for distribution purposes, which will be treated separately. This is known as a "convenience class." The object is to provide a cash out option for creditors willing to take a fixed amount on their claim for a multitude of small claims. Typically, the class will provide for a percentage payment on all claims under $500 or $1,000. The idea is to eliminate substantial bookkeeping expenses that may be necessary to make larger payments to the multitude of small claims. In some middle to small cases, proponents have attempted to manipulate the convenience class by setting the amount of the convenience class cutoff high enough to include all of the trade creditors, but exclude the holders of unsecured deficiency claims. For example, in a typical single asset case involving an apartment building or other project where the sole asset of the case is the building, the debtor, in proposing a plan, may provide for a convenience class of all claims under $10,000. The dollar figure would be chosen to include all trade class claims, but exclude the holder of the undersecured claim against the building. This virtually guarantees that the trade creditors will accept the plan. The plan may still be confirmed under 11 U.S.C. 1129(b) under certain limited circumstances (discussed below) because the convenience class has accepted. The confirmation requirements often lead to negotiations between the creditors over both classification and treatment issues. Again, the case law in this area is still developing, but a consensus seems to be building that so long as the proponent of the plan (whether the debtor or someone else) has a rational basis in fact for the segregation of creditors into different classes, then the classification scheme may be approved.

TREATMENT OF UNSECURED CLAIMS

The concepts of classification and treatment of unsecured claims are very closely interwoven. As mentioned above, some courts have held that even though a proponent of a plan may separately classify different types of unsecured creditors, they must all be treated the same in the plan. (This makes little sense because separate treatment is often the key to voting on the plan.) Generally, however, the courts have not taken such a narrow view and the evolving rule seems to be that separate classification and treatment are possible, as long as there is a rational factual basis for the separate classification and treatment.

The treatment provision of the plan of reorganization tells what will be received under the plan as proposed. Depending upon the type of plan proposed, the plan language will detail what, if anything, will be distributed to creditors on account of their claims in that class. Generally, the treatment and the plan will be dictated by the requirements of the confirmation process discussed below.

There is no typical Chapter 11 plan, and plans fall into a variety of general types. Plans range from full payment immediately or over a period of years to a zero percent payment to unsecured creditors. Plans are generally classified as "compromise plans" if they provide for less than full payment and as "extension plans" if they provide for full payment with or without interest over a period of time. Some plans, commonly referred to as "pot plans," call for some of the debtor's assets to be set aside for liquidation and distribution to creditors in accordance with the priority of their claims. A creditor's primary concern is to understand the amount of payment of its claim. A plan may provide for no payment to general unsecured creditors. The unsecured creditors are wiped out and the debtor's assets liquidated and the proceeds paid to secured and priority creditors. From a general unsecured creditor's point of view, a plan providing for no payment is confirmable only if there is no equity in the assets, whether based on liquidation or going concern value, and if the debtor's stockholders or owners will retain no interest in the business after confirmation. (*See* the confirmation discussion that follows.) Generally, a plan that wipes out unsecured creditors also wipes out equity holders.

Partial payment plans fall into a variety of categories. These plans generally provide for cash payment of a certain percentage of unsecured claims either upon confirmation or in periodic payments over a period of years. From a tactical point of view, of course, the proffer of an immediate 15 or 20 percent cash payment is generally going to be received more favorably by creditors than a payment of the same amount over a period of time. Thus, the amount and the timing of the payment will be key negotiation points in the formulation of the plan.

The formulation of the percentage to be paid to unsecured creditors will largely depend upon the assets of the bankruptcy estate. This often leads to disputes over valuation methods. Generally, a liquidation value is placed on the debtor's assets based upon the net distribution to unsecured creditors in the event of a *forced sale* of the business. If this involves inventory or work in progress of a small manufacturer, the liquidation value of the complete inventory may be substantially less than the cost value on the company's books. Likewise, depending on the local economy, the sale of both real and personal property at auction may bring substantially less than the same property would if the business is sold as a going concern. Thus, a creditors' committee will often place a going concern value on the business in the negotiations and may even try to locate a potential buyer for the whole business. An offer to purchase the business assets as a going concern is a strong bargaining position in dealing with a debtor or secured creditor in plan negotiations.

The courts will look to the plan provisions to determine the appropriate valuation method. If the debtor proposes to retain the business and continue the operation with the shareholders or principals retaining an equity interest, the court will generally require a going concern value in setting the minimum distribution to unsecured creditors. On the other hand, if the plan provides for liquidation of the assets, whether over a period of time or through an immediate auction, the court will generally accept a liquidation valuation.

In evaluating a proposed plan, a creditor should compare what is being offered with what might be achieved through a reasonable liquidation process. The liquidation value is the floor; if the plan offers more than would be received in a liquidation under Chapter 7, then the creditor should evaluate whether the plan is confirmable.

While under optimum conditions a debtor might be sold as a going concern for a value sufficient to satisfy all creditors, this rarely occurs in the bankruptcy context. Unless a buyer is known who is willing to pay a going concern value for the debtor's business, the creditor should very carefully consider what the proponent of the plan offers. That offer, of course, should be compared with the minimum dividend that would be payable in the event of a complete and quick liquidation of the debtor's assets through auction. However, if the liquidation dividend exceeds what is being offered, the plan is not confirmable. On the other hand some debtors will take the position that if they are offering more than what would be obtained in liquidation, the plan can be confirmed even if the creditors reject it. This is not always the case. (*See* the confirmation discussion below.) As a general rule, it will be difficult to obtain court approval of a plan which allows shareholders to retain their stock if rejected by unsecured creditors, even if the plan pays a dividend equal to or greater than the liquidation value.

A pot plan involves the setting aside of some of the debtor's assets for distribution to creditors. Often, the valuation of those assets is speculative. The assets may consist of an interest in litigation, specific properties or certain proceeds of the sale of a debtor's business or assets. In limited cases a secured creditor or someone else will put up a specific amount for distribution to unsecured creditors *pro rata* based on their claims. These are "pot plans" since the proponent is putting up a "pot" of assets for distribution to unsecured creditors. The amount of assets distributed to the pot will be divided *pro rata* among all allowed unsecured claims.

Since the value of the assets to be placed in the pot and the total amount of allowed claims are often uncertain, it is difficult to calculate the distribution to unsecured creditors. In many cases, the total amount of the unsecured claims either has not been determined or is the subject of litigation at the time the plan is proposed.

Pot plans are most often proposed where the proponent is willing to put up a fund in return for the unsecured creditors accepting the plan. In certain circumstances there may be tax advantages to maintaining the corporate entity of a debtor in possession through the bankruptcy process. For instance, a debtor's loss will carry forward and other tax attributes may be preserved and used to shelter post-petition income. While a discussion of those tax advantages is beyond the scope of this work, they may figure prominently in the reorganization negotiations between the parties.

Just as the uncertainties in the valuation of the assets and the amount of class claims make evaluation of a proposed pot plan difficult for creditors, those same uncertainties make it difficult for the court to approve confirmation. If creditors reject the proposed plan, the court must find that the liquidation value is actually being paid to unsecured creditors. The plan proponent may not be able to convince the court that that is true.

Full payment or extension plans are rarely proposed, but are always an option. A simple extension of the existing unsecured debt over some period of time is always an option. This is particularly attractive where the debtor has suffered a setback in a start-up business, but has a viable operation that will, over a period of time, generate sufficient cash flow to pay back the debts. A full payment plan, of course, depends upon the viability of the business. Often, the debtors are overly optimistic about future cash flow. In evaluating a proposed extension plan, the creditor should consider whether there is any interest to be paid on the claim and the true viability of the debtor's business. Again, the payment over a period of time, with or without interest, must be compared with the liquidation value of the debtor's business. If, in liquidation the debtor would generate sufficient assets to pay all claims, the debtor will be required to pay interest on all claims.

In a limited number of cases, the debtor or other proponent will offer a stock distribution or a "debt for equity swap." In this situation, a creditor will be asked to give up its claim against the debtor in return for stock in the corporation or in a new corporation to be formed to take over the assets of the debtor. Creditors may not wish to hold the stock. The value of the stock may be virtually nil since there may be no market for it. On the other hand, in the K-Mart Chapter 11 proceeding, unsecured creditors were given stock for their unsecured claims. Those who held on to the stock found themselves receiving substantial returns as the stock value increased dramatically following confirmation of the K-Mart Chapter 11 plan. Nevertheless, distribution of stock may create substantial securities law problems for the proponent and for the creditor. While the discussion of securities problems is

generally beyond the scope of this work, a creditor may want to consider the advisability of owning, along with many other creditors, a small piece of the new debtor where there may be little chance of selling the stock aside from potential securities problems.

A stock distribution or debt for equity swap plan presents few drafting problems and the only points for negotiation are the value to be placed on the stock for purposes of the swap. Since the Bankruptcy Code expressly prohibits the issuance of nonvoting stock, any stock issued must be voting stock. This will lead to some interesting control questions once the debtor is reorganized. Since a debt for equity swap plan will generally identify the initial board of directors and their terms, owning stock in a business controlled either by other creditors or indirectly by management may occur, which can continue its pre-petition ways.

A variation on a debt for equity swap plan is a two-step proposition in which someone interested in acquiring the debtor's operation proposes a stock distribution or debt for equity swap and then, at the same time, offers to acquire the newly issued stock at a discount from the former creditors.

Depending on the complexities of the case all of the above options may be included in a single plan. For example, creditors may be offered an opportunity to cash out their claims or accept issuance of stock in return for their claims. They may be offered the alternative of partial payment of their claim on the effective date of the plan. Since protracted litigation is rarely in anyone's interest in these circumstances, the creditor's consideration of any proposed plan ought to be limited to a review of what is offered against what might be achieved in liquidation or if they should propose some other plan. All too often, creditors will see greater value in the debtor than actually exists and will reject a partial payment plan, forcing the company into liquidation. Once the liquidation is complete, of course, there may not be enough to satisfy priority and administrative claims.

Classification and Treatment of Equity Interests

Any plan of reorganization must provide for the classification of any interests held by equity security holders and for their treatment. Equity security holders include stockholders in a corporation, members of a limited liability company and limited partners in a limited partnership. The Bankruptcy Code does not deal very well with a sole proprietorship business even though the sole proprietor has an ownership interest in the assets akin to, but distinctly different from, that of a stockholder. A sole proprietorship business would be an individual Chapter 11 or 13. In a sole proprietorship, partnership or a corporate plan, the plan must specifically classify the ownership interest and provide for treatment. That treatment will vary depending upon the type of plan. As a general rule, however, equity holders are last in line for any payment, or other distribution, and a plan must be accepted by creditors or pay them in full before equity holders receive or retain anything.

Provision for Execution of Plan

At the very least a plan should describe how the assets, claims and interests will be treated and how any sale, liquidation or restructuring provided in the plan will be accomplished. Generally, all administrative expenses must be paid in full upon confirmation. If the plan provides for restructuring, the transfer of assets, issuance of stock and payments to creditors must be carefully detailed. If a liquidation of assets is contemplated, provision for conduct of the sale, payment of expenses and distribution of the net proceeds must be carefully set out. Above all, a plan should establish clear deadlines for all sales, transfers and distributions.

The greatest danger from a creditor's point of view is that a liquidating plan will not specify the means of liquidation of assets and the dates for payments to creditors. Thus, for example, a liquidation plan for a company with substantial real estate might allow the debtor six months to sell the real estate through a broker and then provide for an auction to be held within a certain period thereafter if the broker is unsuccessful in locating buyers. The plan may specify a minimum auction price, the maximum expenses to be incurred in connection with the auction and other details of the auction. It should also detail the distribution of the proceeds from the auction. Similarly, a cash-out plan should provide, in detail, how claims will be determined and a date for payment of the dividend on unsecured claims.

Other Plan Provisions

A plan may contain a variety of optional provisions, again depending upon the type of plan and its acceptance by creditors. A typical liquidating plan or pot plan will provide for the creation of a liquidating trust and the appointment of a trustee or other administrator to handle the assets to be liquidated and distributed to creditors, claims reconciliation, including objecting to disputed claims, and the prosecution of claims against third parties.

A plan may further provide for the vesting of all of the debtor's assets in a new entity subject to existing security interests. It may provide for the retention of the right to pursue preference and other actions by the newly formed entity. Some plans have provided for specific limits on management salary and restricted a debtor's right to make capital purchases pending payments to unsecured creditors. Still other plans have limited management perquisites pending the payout to creditors. Generally, a plan will provide for the retention of jurisdiction by the bankruptcy court to resolve disputes concerning interpretation of the plan and to hear preference actions retained by the debtor.

The creditor should be aware of one restriction on plan provisions that the courts have generally upheld: A plan may not discharge guarantors who are not themselves in bankruptcy unless the creditor holding the guarantee specifically approves that provision. A creditor holding a guaranty must object to a plan that provides for a discharge of the guaranty. The courts that have considered the issue have generally held that the bankruptcy court does not have jurisdiction to discharge a guarantee executed by a nondebtor in favor of a creditor. However, at least one court has upheld such a provision where the creditor did not object to the confirmation of the plan.

MANDATORY DISCLOSURE

Preliminary Comment

Fundamental to the Chapter 11 process is the statutory requirement that a proponent of a plan make disclosure of certain information in conjunction with the solicitation of the votes on the plan. While the disclosure requirements may vary considerably depending upon the proponent of the plan and the plan's provisions, before the plan can be submitted to creditors for solicitation of votes and formal confirmation, the proponent must submit to the court a disclosure statement for approval. (11 U.S.C. §1125). The parties in interest are given an opportunity to object to the disclosure statement submitted.

The courts have made every effort to avoid rigidly structuring the disclosure process with strict disclosure requirements on the theory that the amount of disclosure required should reflect the complexity of the plan. The disclosure process can, however, be overly cumbersome and expensive for smaller debtors. BAPCPA included specific mandates and leniencies for small business debtors. The small business provisions of BAPCPA will be explained separately, below. However, in some courts an accelerated Chapter 11 process has been informally approved where the disclosure statement is approved at the same hearing as the confirmation hearing.

A final preliminary comment: Getting embroiled in protracted litigation over the sufficiency of the information disclosed by the proponent of the plan is counterproductive. Not only does it cost the estate money for fees and expenses, it may also delay a vote on a plan which otherwise might not be confirmable. Moreover, it may delay the confirmation of a plan that is dependent upon speedy execution for distribution of any assets to creditors. Many courts actively discourage objections to the disclosure statement unless the disclosure statement is patently inadequate. Much of the risk is placed on the proponent of the plan because the court will refuse to confirm a plan that is accompanied by an inaccurate or inadequate disclosure statement. A creditor's counsel should be familiar with the particular judge's requirements for disclosure and object only if those requirements are not met.

Disclosure Statement

Before a proponent of a plan can solicit votes from creditors and seek confirmation thereof, the disclosure statement must be submitted to the court and approved. (11 U.S.C. §1125). Occasionally, a proponent will file a plan and then, as a delaying tactic, withhold the filing of a disclosure statement.

Generally, however, a plan and disclosure statement are filed in close proximity to each other and are interrelated. Indeed, in some of the simpler cases, the courts have approved combined plans and disclosure statements.

The first step in the approval process after the filing of the plan and the disclosure statement is to give notice to creditors that the disclosure statement has been filed and set for hearing. Not all creditors will receive copies of the plan and disclosure statement unless they request them. Only the creditors' committee and the major secured creditors will receive copies automatically. If not on the committee, the creditor should contact the debtor's lawyer and request a copy. The request should be in writing. Or a copy may also be obtained through PACER. In larger cases, there are often websites set up by the debtor or by the creditors' committee, which will provide free access to all pleadings and other important documents filed with the court. Prior to paying for a document through PACER, a creditor should check to see if a website has been set up or other sources are available to provide this information at no charge. The court will set a hearing date at least 25 days after the mailing of the notice of the filing of the disclosure statement. Creditors will be given an objection deadline. For the most part, if the case involves experienced counsel, the disclosure statement hearing will be perfunctory and counsel and the court will quickly approve the disclosure statement. Again, it is often counterproductive to file detailed objections to the disclosure statement since that merely delays resolution of the case.

Section 1125(a)(1) requires that a bankruptcy court take into account the complexity of the case, the benefit of additional information to creditors and other parties in interest and the costs associated with providing any additional information when the court considers the adequacy of information contained in the disclosure statement. The disclosure statement must also discuss the potential federal tax consequences of the Chapter 11 plan to the debtor, any successor of the debtor, and a hypothetical investor typical of the holders of claims or interests in the case that would enable such a hypothetical investor of the relevant class to make an informed judgment about the plan.

Section 1111(b) Election

Certain *under*secured nonrecourse creditors are given the opportunity under 11 U.S.C. §1111(b) to elect to have their undersecured claim treated as though it were fully secured. An election to be treated under §1111(b) means that an undersecured creditor is treated as fully secured for confirmation purposes. If the creditor is presented with a §1111(b) election, they should consult counsel about a response.

Solicitation of Acceptances and Rejections

Only after the court has approved the disclosure statement may anyone solicit rejections or acceptances of a plan by creditors and other parties in interest. Often, the creditors' committee will oppose or support confirmation and assist in solicitation of acceptances or rejections by sending a letter to the parties soliciting either acceptance or rejection of the plan. Great care should be taken, however, if the creditor solicits rejection of a plan not to inject information into the solicitation letter that either has not been approved by the court or goes beyond the disclosure materials. Before soliciting acceptances or rejections of a particular plan the creditor should consult counsel.

BAPCPA added Section 1125(g) to permit an entity to solicit acceptances or rejections of a plan from a holder of a claim or interest if the holder of such claim or interest was solicited before commencement of the bankruptcy case in a manner that complied with applicable non-bankruptcy law, and to continue soliciting acceptances subsequent to the bankruptcy filing. This provision provides explicit statutory authority for a party to solicit acceptances or rejections prior to and after a bankruptcy case being filed, as is frequently done in a "prepackaged" Chapter 11 case.

VOTING PROCESS

Majorities Required

The voting process is relatively simple. Each creditor or interest holder with a claim in a particular class is asked to return a formal ballot either accepting or rejecting the plan. Only those plan ballots actually returned are counted in determining whether the plan is accepted or rejected. A class of creditors is deemed to have accepted the plan if those holding at least two-thirds in amount and one-half in number of the allowed claims in the class *actually voting* accept the plan. (11 U.S.C. §1126). Conversely, a class is deemed to have rejected the plan if *either* more than one-third in amount or more than one-half in number of the allowed claims actually voting on the plan reject it. However, the Code allows the bankruptcy court to strike any vote that is procured in bad faith or not in accordance with the Bankruptcy Code. For example, a ballot cast against the plan in return for payment by an opponent is in bad faith and not in accordance with the plan.

Therefore, creditors holding a substantial percentage of the unsecured claims or other claims in a particular class have a strong negotiating position in that their rejection may cause the class to reject the plan. Quite often, an unsecured creditors' committee, which normally includes the largest unsecured creditors, will hold a substantial percentage of the unsecured claims. The committee's acceptance or rejection of the plan may be key to the confirmation process. As will be discussed below, the debtor or other proponent must obtain the necessary majorities in each class or go through the cramdown procedure under 11 U.S.C. §1129(b).

Procedure

Ballots and Voting

The proposed plan is sent out to the creditors with an accompanying form ballot. Generally, ballots must be returned to the court or the plan proponent by a particular deadline. If the creditor intends to vote on a plan the creditor should return the ballot in a timely fashion. Allow extra time for returning the ballot by mail, as ballots received after the deadline, even though they may have been mailed prior to the deadline, are not counted.

After the deadline, counsel for the proponent prepares and files a certificate of voting form summarizing the timely returned ballots. Generally, copies of the ballots will be attached to the certificate of voting, which will list and total all ballots cast in each class. Note that even if the committee is actively soliciting rejections, the ballots must still be returned to the court or the proponent of the plan rather than to the committee, unless the court orders otherwise. The certificate of voting should list all ballots, whether late or disputed, and leave it to the court to resolve any disputes over the result.

Claims Objections

Occasionally, in an effort to affect the voting, the proponent or the debtor will object to a particular claim and ask that the court disallow it for voting purposes. Usually, the basis for the disallowance is that the claim is in some way disputed, contingent or unliquidated. Most objections to a particular claim are purely a tactical effort to disenfranchise a particular creditor during the voting on the plan.

If the creditor holds a claim and receives such an objection, the creditor will need the assistance of counsel to respond in a timely fashion. Generally, the creditor must respond to the objection and request a hearing before a deadline or appear at a hearing prior to the confirmation hearing for a preliminary ruling by the court on the objection. Failure to respond in a timely manner may result in disallowance of the claim.

Alternate Plans

Occasionally, competing plans will be submitted to creditors simultaneously. The better practice is to have the competing plans submitted with a joint ballot with a blank for creditors to express their preference for one plan over the other. The case law suggests that the court should confirm the plan preferred by a majority of creditors if both plans are, in fact, confirmable.

CONFIRMATION PROCESS

Procedure

Despite its apparent intricacy, the confirmation process is relatively straightforward. If no objections are lodged to the confirmation of the plan and creditors in the necessary quantity and amount accept the plan, the confirmation hearing is often a very perfunctory process and the plan is confirmed.

The process begins with the filing of the plan and disclosure statement. Once the disclosure statement is approved as containing the necessary information (described above), a notice of a confirmation hearing is mailed to all creditors together with a copy of the plan and disclosure statement. A court may direct the plan proponent to mail out both the plan and disclosure statement and combine the hearings thereon. This will shorten the process. A copy of the plan and the disclosure statement will be mailed to each creditor entitled to vote on the plan, with the notice of the confirmation hearing and a ballot for voting. The notice will identify the proponent of the plan and set out deadlines for filing objections and for returning the ballot and specifying the person or entity to receive the ballots. The ballots will be returned either to the court or to the proponent of the plan, depending upon the practice in the local court. In voting on the plan a creditor should follow the directions contained in the notice of the confirmation hearing on the return of the ballot. Ballots must be timely received to be counted.

Generally, any objections to confirmation must be filed a week or so before the confirmation hearing set out in the notice. The objections to confirmation should set out, in detail, the bases for the objection by the party in interest. An objection will generally require the assistance of counsel.

Some courts accelerate the process by combining the confirmation hearing and the disclosure statement hearing, especially in smaller cases, and that is the norm in small business Chapter 11s. The court first reviews the disclosure statement and, if it is acceptable, turns to the confirmation of the plan. If there are errors in the disclosure statement, it will have to be corrected and resent. This may cut out some 30 to 45 days in the confirmation process.

Preconfirmation Modification

In a complex case, it is not uncommon for the debtor or other proponent to submit preconfirmation modifications to the plan, even up to the time of the confirmation hearing. The Code specifically permits modification of the plan up until the time of that hearing. Unless the proposed modifications require revoting, the modifications can be included in the plan as confirmed at the confirmation hearing. Typically, such last-minute modifications affect a single unsecured or secured class. The plan does not need to be resubmitted to creditors for a general vote if the modification improves the treatment for a particular class or does not affect all classes.

Section 1127(f) requires any modification of a Chapter 11 plan prior to confirmation to satisfy Sections 1121 through 1128 and the plan confirmation requirements of Section 1129. It further provides that the modified plan shall become the plan only after there has been disclosure as the court may direct under Section 1125, notice and a hearing on the modification, and court approval of the modification.

Procedure at Confirmation Hearing

The procedure at a confirmation hearing is generally routine. However, if objections are filed and depending on the complexity of the case, the confirmation hearing may become extremely complicated. 11 U.S.C. §1129(a) sets forth the criteria that must be established in order for a plan to be confirmed. The confirmation hearing always begins with a requirement that debtor's counsel present a certificate regarding the voting by creditors on the plan. Counsel for the proponent (which may be an entity other than the debtor) will be asked to place the results of the voting into the record. This recitation is necessary to establish the fact that at least one class of impaired creditors has accepted the plan. Once that fact has been established, the court then turns to the confirmation requirements set forth in §1129 of the Bankruptcy Code.

In simpler cases, the court may require nothing more than a recitation by the Chapter 11 debtor's counsel that each of the 16 points of §1129(a) has been met. In other instances, the court will require

evidence on each point of §1129(a) to be established. A creditor who opposes a plan should consult counsel to determine if the plan can be defeated because each part of §1129(a) has not been met. The primary areas of dispute upon which the courts generally focus are feasibility of a plan and whether the plan has been proposed in good faith.

BAPCPA Additions to §1129

With respect to individual Chapter 11 debtors and small business cases, BAPCPA added provisions to §1129(a) that must be met in order for a plan to be confirmed. Of particular interest to trade creditors is §1129(a)(15) which provides that in an individual Chapter 11 case, the value—as of the effective date of the plan—of property to be distributed under the plan to the holder of an unsecured claim must equal either the amount of the unsecured claim or not less than all disposable income to be received during the following five-year period.

Confirmation without Cramdown

If all classes of creditors and interest holders have accepted the plan by the necessary majorities, there is no need to resort to the cramdown process to confirm the plan. Assuming that the court finds that proposed distribution to unsecured creditors will at least equal that which would be made in a Chapter 7 (the liquidation test), the court may confirm the plan as proposed. Only if a class of impaired creditors has rejected the plan is it necessary to refer to the cramdown provisions of the Bankruptcy Code. Note that even a confirmed plan may be subject to postconfirmation modification, however.

Cramdown Process

Overview

The Bankruptcy Code permits the bankruptcy court to confirm a plan with respect to a class or several classes of creditors who reject a plan. Either a class that votes to reject a plan or a class that does not accept by the majority required under 11 U.S.C. §1126 is a rejecting class. (*See* the discussion above of the voting process.) A class containing a single creditor who fails to vote on the plan is deemed to have rejected the plan since there are no positive acceptances *per se.*

Confirmation over a rejecting class's vote is known as cramdown in common parlance. It is a series of three unrelated processes that depend upon the type of class that is involved. The provisions are different for secured creditors, unsecured creditors and interest holders. The process of forcing rejecting creditors or interest holders to abide by the plan of reorganization is complex and involves many difficult factual and legal issues. The process of cramming down a plan on dissenting secured or unsecured creditors is probably threatened more often than it is accomplished. Ideally, of course, the debtor, in proposing a plan, will propose a plan that will be confirmable even if it is not accepted by a majority of the creditors. However, cash constraints and the need to write off substantial unsecured debt to make the business viable mean that rarely happens. Only rarely is the debtor in a position to propose a full payment plan with an appropriate interest rate that is feasible under market circumstances at the time it is proposed. Anything short of that may require cramdown with all the legal and factual problems it entails. The bottom line is that cramdown is more often threatened than accomplished.

ABSOLUTE PRIORITY RULE

A major creditor protection provision is a codification of the court-developed *absolute priority* rule in 11 U.S.C. §1129(b). In its simplest application it bars confirmation of any plan that preserves the ownership of the equity security holders unless all classes of claims have either voted to accept the plan or will be paid in full. A complete analysis and explanation of the complexities of the absolute priority rule is beyond the scope of this text, but one or two examples should assist in understanding it. Assume that the debtor is a publicly held corporation operating a chain of retail stores. Aggressive expansion left the debtor with substantial trade debt (all unsecured) and a huge bank debt secured by

all of the debtor's real estate, inventory and receivables. There are no assets that are not covered by the bank's lien. The secured debt is undersecured because the value of the collateral is less than the debt. The debtor files a Chapter 11 case and proposes a plan to pay the secured debt in full and trade creditors 15 percent of their claims. Equity holders will retain their stock and make no new capital contributions.

Even though the 15 percent is more than they would receive in liquidation, the trade creditors resoundingly reject the plan and the creditors' committee files an objection to confirmation. The debtor generally cannot cramdown the plan over such objections because the equity security holders' retention of their stock violates the absolute priority rule.

Assume an individual with a professional practice and substantial personal debt files Chapter 11 and a plan proposing to pay 5 percent of claims to the unsecured creditors and retain the practice. The practice is worth less than the proposed total payment to creditors. The creditors reject the plan. The plan cannot be confirmed over their objection because the debtor will retain the business.

While cramdown is usually considered a threat that the debtor makes against creditors, there are situations in which interest holders can cramdown a plan against a rejecting class of creditors. Some courts allow what has been called the "new value exception" or the "new value corollary" to the absolute priority rule, under which a plan can be confirmed over the objection of a dissenting class if the owners of the company contribute new value to the reorganization effort. This exception to the absolute priority rule is complicated and has been overly simplified for purposes of this discussion. Indeed, it was hoped that the United States Supreme Court would resolve the issue for once and for all in a case decided in the late 1990s (in which NACM filed a "friend of the court" brief). Unfortunately, that case raised more questions than it answered and creditors cannot know for certain the extent to which they can rely on the protection set out in the absolute priority rule. If faced with a cramdown situation, whether the claim is secured or unsecured, a creditor should consult counsel.

POSTCONFIRMATION PROBLEMS

Plan Modification

Naturally, not all plans work exactly as intended. The Code, therefore, permits the modification of a confirmed plan before it is substantially consummated. Only the proponent of a plan can move for postconfirmation modification. Thus, the creditors, unless they proposed and confirmed the plan, are barred from seeking modifications of the plan. The usual issue is whether the plan has been so substantially consummated that it is not amenable to postconfirmation modification. Generally, if the debtor has transferred all property dealt with under the plan to creditors or other entities and has begun payments to creditors pursuant to the terms of the plan, the plan has been substantially consummated and is not subject to modification. Any default must be dealt with as a breach of contract.

Most often, postconfirmation modifications are minor and will be directed toward correcting technical errors in the plan, such as the omission of a secured creditor or dealing with other details relating to a transfer of property. Occasionally, however, the debtor or some other proponent will attempt to redo the plan with major changes in payments to creditors, etc., based on poor postconfirmation operating results. The court will consider this type of major modification if the plan has not been substantially consummated. If the plan modification alters the rights of the creditors under the originally confirmed plan, the modification must generally be submitted to creditors for a vote.

Case Dismissal Postconfirmation

Under very limited circumstances, a court may consider dismissal of a case postconfirmation. Again, assuming that the plan has not been substantially consummated, the court has the option of dismissing a bankruptcy case postconfirmation. The court will rarely consider a motion for dismissal postconfirmation, however, because of the difficulties in unraveling the effects of confirmation.

Postconfirmation Conversion

Under certain limited circumstances, the court will consider postconfirmation conversion of the case to Chapter 7. Generally, conversion will follow on the debtor's failure to effectuate substantial consummation of the confirmed plan or a material default by the debtor with respect to a confirmed plan. Some plans provide for the conversion of the case upon the happening of a specified event. Even in these cases, the conversion will require a motion to the court and notice to creditors.

If the debtor has failed to make payments provided under a confirmed plan, a creditor should also consider suing the debtor under the plan in state court to collect whatever payments have been missed, or the entire balance due if the plan contains an acceleration provision upon the occurrence of a default.

Revocation of Confirmation

The Code specifically provides that the court may, within 180 days of the entry of the order for confirmation, revoke confirmation of the plan if, and only if, the order of confirmation was procured by fraud. (11 U.S.C. §1144). Generally, an adversary complaint to revoke the confirmation order must be filed against the debtor or the proponent of the plan. Note that such a motion must be filed within 180 days after the entry of the order of confirmation.

Enforcing the Plan

While a plan may provide for payments over a period of time, there is some question as to where the suit should be filed to enforce payments. The bankruptcy court may retain jurisdiction after confirmation of the plan to resolve adversary proceedings and claims objections, but generally the bankruptcy court's jurisdiction over the case will terminate once substantial consummation is achieved. Prior to that time, at least theoretically, the bankruptcy court has jurisdiction to entertain a suit against the debtor for any missed payments. There is a split in authority as to whether a creditor may sue for the entire outstanding balance on its claim in the event of default on the plan payments and the plan is silent on acceleration of the plan indebtedness in the event of a default. For example, if the creditor holds a claim of $100,000 and the debtor has agreed to pay 15 percent over three years, the courts are divided on whether the debtor's failure to make the first payment renders the entire $15,000 due under the plan collectible. Some courts have held that only the missed payments can be enforced through legal action. Other courts have found that a default in a single payment renders all payments due under the plan.

The courts are generally in agreement that an action to enforce the plan may be brought in state court. Particularly if substantial consummation has been achieved and the bankruptcy court has terminated its jurisdiction, the state court would be the appropriate forum for collection of the plan payments.

TRENDS TOWARD QUICKER CHAPTER 11 PROCESS

There has been a trend in recent years toward a quicker Chapter 11 process. For many companies filing Chapter 11, their bankruptcy cases have moved faster either through a sale process or through a prepackaged or prearranged plan of reorganization. The old fashioned Chapter 11 reorganization case, where the business is fixed during the case and a plan is negotiated with creditors, is now the exception rather than the rule.

Section 363 Sales

A debtor can sell all or substantially all of its assets "free and clear" of all liens, claims and encumbrances pursuant to Section 363 of the Bankruptcy Code. Unlike a traditional reorganization that culminates in a plan of reorganization, the sale process is far quicker, generally only taking a few to

several months. After the sale closes, a liquidating plan is filed and confirmed, the case is converted to a Chapter 7 bankruptcy case, or the case is dismissed via some form of structured dismissal.

A Section 363 sale is generally a multi-step process that can either begin in advance of or after the Chapter 11 is filed. In either case, a debtor, with the assistance of an investment banker or other professionals, will contact numerous parties that might be interested in purchasing the debtor's business or assets. These parties must sign a confidentiality agreement as a prerequisite to being given access to financial information about the debtor and access to the debtor's management team. If interested in moving forward, a potential purchaser will generally submit a term sheet or letter of intent to the debtor. Once a prospective purchaser reaches an agreement with the debtor, the agreement is memorialized in a stalking horse asset purchase agreement that is eventually filed with the bankruptcy court.

The party purchasing a debtor's assets is referred to as a "stalking horse" because it sets the floor for bids submitted at an auction. In return for setting this floor, the stalking horse is provided certain protections. The protections oftentimes include a break-up fee (usually approximately 3 percent of the purchase price), plus reimbursement of expenses, that are only paid if a third party purchases the assets for a higher or better price.

Once the terms of the asset purchase agreement are agreed upon, the debtor will file a motion with the bankruptcy court for approval of: (1) bid procedures; and (2) the sale (after an auction if competing bids are submitted). While an auction does not necessarily have to take place, especially if there is substantial pre-petition marketing of the debtor's assets, the courts generally frown upon private sales that dispense with the opportunity for competitive bids because they do not allow for the value of the assets to be market tested in a transparent fashion.

The bid procedures are generally a product of negotiations between the debtor, the stalking horse bidder, the pre-petition and/or post-petition secured lender (DIP financing lender) and a creditors' committee if one is appointed. Oftentimes, the deadlines included in the bid procedures are governed by the order authorizing a debtor to obtain Chapter 11 financing and are very strict and short. If the parties cannot agree on bid procedures, a hearing will be held and the bankruptcy court will address any pending objections.

The bid procedures usually include:

(1) deadlines by which bids must be submitted;
(2) a minimum overbid amount for all bids other than the stalking horse bid;
(3) bid increments to be used during the auction (the amount by which a bid must exceed a prior bid);
(4) requirements that bids must be in writing and include a redline showing changes from the stalking horse asset purchase agreement;
(5) deposit parameters;
(6) a requirement that bids be irrevocable;
(7) a requirement that there are no contingencies in a competing asset purchase agreement (including, but not limited to, financing, board and other internal approvals, asset inspection, due diligence, etc.);
(8) a requirement that evidence be provided demonstrating that the bidder has the financial wherewithal to close the transaction;
(9) a requirement that the bidder(s)' identity is disclosed;
(10) consultation rights for various interested parties (including the creditors' committee, secured creditor, DIP financing lender, etc.);
(11) procedures and deadlines for dealing with the assumption and rejection of executory contracts;
(12) parameters associated with a secured lender's right to credit bid its secured claim;
(13) the auction and sale hearing dates; and

(14) deadlines governing when interested parties must object to the bid procedures, the sale, and the assumption/rejection of contracts and attendant cure amounts.

The stalking horse bidder usually seeks bidding procedures and protections that tilt the sale process in its favor. Those procedures and protections include, among other things, large break-up fees and expense reimbursement rights that must be added to a competing bidder's initial bid, large bid increments, and large deposit requirements.

Like the stalking horse bidder, the parties interested in submitting a competing bid will be required to sign a confidentiality agreement as a prerequisite to being granted access to the debtor's financial information and its management.

The bidding procedures provide that, assuming at least one qualifying bid in addition to the stalking horse bid is received prior to the bid deadline, and the competing bid exceeds the stalking horse bid by the amount of the break-up fee, expense reimbursement and any additional amounts required, an auction will be held. If no qualifying bids are received, the auction will generally be cancelled and the sale hearing will take place to determine if the sale to the stalking horse is in the best interest of the debtor's estate. Auctions are usually held at the offices of the debtor's bankruptcy counsel and a court reporter is often present to record the proceedings.

The debtor usually runs the auction subject to the consultation rights provided to third parties in the bidding procedures. There can be several rounds of competitive bidding or the debtor can cut off bidding and request that the bidders make their "highest and best" offer. At the conclusion of the auction, the debtor, on the record, will declare which offer is the highest and best offer. The bidding procedures also provide that the party with the second highest offer will be named as the back-up bidder and be required to honor its bid until the winning bidder closes on the transaction.

Shortly after the auction, the court will conduct a sale hearing. During the hearing, the court will address any pending objections to the sale and then approve or reject the proposed sale. If the sale is approved, the court will enter a sale order approving the sale. Assuming the sale is approved, the closing generally occurs very quickly.

Prepackaged Chapter 11

A prepackaged bankruptcy is a Chapter 11 case where the debtor reaches an agreement with its creditors and other relevant constituencies prior to the filing of the Chapter 11 case. The agreement is documented in a plan of reorganization and voted on by the relevant constituencies before a bankruptcy petition is filed. Trade creditors are usually paid in full in a prepackaged plan.

There are various reasons prepackaged bankruptcies are favored. First, they allow a debtor to shorten and simplify the bankruptcy process. The process to obtain approval of a prepackaged Chapter 11 plan could be as short as 30-60 days after the Chapter 11 filing date. Second, the debtor is able to minimize its legal and other professional fees and other costs generally associated with operating in Chapter 11. Third, a prepackaged bankruptcy limits the uncertainty associated with the Chapter 11 process because the votes needed to confirm a plan are already solicited prior to the filing. Finally, this avenue allows a debtor to maximize going concern value and, in turn, minimize the bankruptcy's impact on trade creditors, customers, employees and day-to-day operations.

Prearranged Chapter 11

A prearranged Chapter 11 case, unlike a prepackaged case, occurs when the debtor reaches an agreement with one or more, but not all, of the debtor's creditor constituencies (most often the debtor's secured lender owed significant sums) on the terms of a Chapter 11 plan prior to the filing of the Chapter 11 case. In a prearranged case, the debtor negotiates with the lender for debtor-in-possession financing, prepares first day pleadings, and prepares a disclosure statement and plan of reorganization for an immediate post-filing solicitation of creditors. The goal is to file for Chapter 11 and oftentimes obtain expedited approval of the disclosure statement and plan of reorganization, and then to exit bankruptcy within several months of the bankruptcy filing date. Trade creditors are not assured full or any payment in a prearranged Chapter 11 case.

SMALL BUSINESS PROVISIONS OF CHAPTER 11

Statistics have shown that a small business cannot survive a Chapter 11 bankruptcy proceeding unless that small business is able to get in and out of the bankruptcy court within a reasonable period of time.

Definition of Small Business

A "small business debtor" is one engaged in commercial or business activities that has aggregate non-insider, non-affiliate, non-contingent liquidated secured and unsecured debts, as of the date of the commencement of the bankruptcy, of not more than $2,566,050. A debtor who meets the definition of "small business" must proceed as a "small business" debtor and comply with the small business provisions of the Bankruptcy Code. The only exception will be if a creditors' committee is appointed, then the debtor is no longer a "small business" debtor.

Duties of a Small Business Debtor

There are additional duties for a small business debtor. They are as follows:

(1) the most recent balance sheet, statement of operations, cash-flow statement and federal income tax return must be filed with a voluntary Chapter 11 petition. Alternatively, a statement under penalty of perjury must be filed stating that no balance sheet, statement of operations, or cash-flow statement has been prepared and no federal income tax return has been filed;
(2) the debtor must attend meetings scheduled by the court or the United States Trustee, including the initial debtor interview, the meeting of creditors and scheduling conferences, unless the court, after notice and hearing, waives this requirement;
(3) the debtor must timely file all schedules and statements of financial affairs, unless the court grants an extension of not more than 30 days, absent extraordinary and compelling circumstances;
(4) the debtor must file all post-petition financial and other reports required by the Bankruptcy Rules or local rules;
(5) the debtor must maintain insurance customary and appropriate to the debtor's industry;
(6) the debtor must timely file tax returns and other required government filings;
(7) the debtor must timely pay all taxes except those being appropriately contested; and
(8) the debtor must allow the United States Trustee or a designated representative to inspect the debtor's premises, books and records at reasonable times and upon reasonable notice.

There are also supplemental reporting requirements for small business debtors. A small business debtor is required to file periodic financial and other reports containing information that includes: (1) the debtor's profitability; (2) the debtor's projected cash receipts and disbursements over a reasonable period; and (3) comparisons of actual cash receipts and disbursements with projections in prior reports. A small business debtor must also state in the report whether it is in compliance with all applicable bankruptcy laws and whether it is timely filing tax returns and required government filings. Additionally, a small business debtor must report if it is timely paying taxes and other administrative expenses when due.

If a small business debtor is not timely making required government filings and/or not making tax and other administrative payments when due, the debtor must report what the failures are and how, at what cost, and when the debtor intends to remedy such failures.

Flexible Rules for Disclosure Statement and Plan

When the bankruptcy court considers a small business debtor's disclosure statement, it must take into account the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost associated with providing any additional information. (This also

applies in all other Chapter 11s.) This section also allows the bankruptcy court to dispense with the requirement of a disclosure statement altogether in cases in which: (1) the debtor is classified as a small business; and (2) when the debtor's plan itself provides enough adequate information. In a small business case, a court can approve a disclosure statement that has been submitted on standard forms approved by the court or adopted under 28 U.S.C. 2075.

Standard Form Disclosure Statement and Plan

Official forms of a plan of reorganization (Form B25A) and a disclosure statement (Form 25B) for small business debtors have been created to achieve a practical balance between: (1) the reasonable needs of the courts, the United States Trustee, creditors and other parties in interest for reasonably complete information; and (2) economy and simplicity for debtors.

Small Business Plan Filing and Confirmation Deadlines

A small business debtor has the exclusive right to file a plan for the first 180 days following the order for relief. This period may be extended after a notice of hearing if: (1) the debtor demonstrates by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time; (2) a new deadline is imposed at the time the extension is granted; and (3) the order extending the time is signed before expiration of the existing deadline. Alternatively, the 180-day period may be extended if the bankruptcy court approves the extension "for cause," an easier standard. A small business debtor must file a plan and a disclosure statement (if any) within 300 days of the order for relief, subject to extension only if the small business debtor satisfies the tougher requirements contained in (1), (2) and (3) above. The passage of these deadlines would result in the debtor's inability to confirm a plan and be grounds for conversion of the case to Chapter 7 or dismissal.

Plan Confirmation Deadline

The court must confirm a plan in a small business case not later than 45 days from the date the plan is filed, provided the plan complies with all applicable provisions of the Bankruptcy Code. This 45-day period may only be extended if: (1) the debtor demonstrates by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time; (2) a new deadline is imposed at the time the extension is granted; and (3) the order extending the time is signed before the existing deadline expires.

Serial "Small Business" Filers and the Automatic Stay

Bankruptcy Code Section 362 (the automatic stay section) contains subsection (n) which is applicable only to small business cases. The automatic stay does not apply in a case in which the debtor: (1) is a debtor in a small business case; (2) was a debtor in a small business case that was dismissed by an order that became final in the two-year period ending on the commencement of the current bankruptcy case; (3) was a debtor in a small business case in which a plan was confirmed in the two-year period ending on the commencement date of the current bankruptcy case; or (4) is an entity that acquired substantially all the assets or business of a small business debtor described in (1) through (3), above, unless the entity can establish that it acquired substantially all of such assets or such business in good faith.

However, subsection (n) does not apply to an involuntary bankruptcy filing where there was no collusion between the debtor and petitioning creditors, or where the debtor can prove: (1) the filing of the petition resulted from circumstances beyond the control of the debtor not foreseeable at the time the case then pending was filed; and (2) it is more likely than not that the court will confirm a feasible plan, but not a liquidating plan, within a reasonable period of time.

BASICS OF CHAPTER 12

Overview

In the mid-1980s, the farm economy in this country was under a great deal of financial stress. Many farmers and farm lenders were facing bankruptcy or insolvency of one kind or another. Chapter 11 did not work very well to reorganize farmers because of the absolute priority rule (discussed above) and the general complexity of the process. Moreover, the disclosure requirements of Chapter 11 were generally too cumbersome for the individual farmer.

As a result of pressure from various farm groups, Congress adopted Chapter 12 of the Bankruptcy Code in 1986, providing special provisions relating to the reorganization of family farmers. Chapter 12 shares some elements of Chapter 11 and Chapter 13. Although originally intended as a temporary measure for family farmers, Chapter 12 is now a permanent part of the Bankruptcy Code as a result of BAPCPA.

Eligibility

Eligibility for Chapter 12 was expanded to include family fisherman in addition to family farmers, yet there are clear distinctions between these two types of Chapter 12 entities.

Definition of Family Farmer and Monetary Requirements. The term "family farmer" means:

(1) an individual or individual and spouse engaged in a farming operation whose aggregate debts do not exceed $4,153,150 and not less than 50 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse unless such debt arises out of a farming operation), on the date the case is filed, arise out of a farming operation owned or operated by such individual or such individual and spouse, and such individual or such individual and spouse receive from such farming operation more than 50 percent of such individual's or such individual and spouse's gross income for:
   (a) the taxable year preceding; or
   (b) each of the 2nd and 3rd taxable years preceding; the taxable year in which the case concerning such individual or such individual and spouse was filed; or

(2) corporation or partnership in which more than 50 percent of the outstanding stock or equity is held by one family, or by one family and the relatives of the members of such family, and such family or such relatives conduct the farming operation; and
   (a) more than 80 percent of the value of its assets are those related to the farming operation;
   (b) its aggregate debts do not exceed $4,153,150 and not less than 50 percent of its aggregate noncontingent, liquidated debts (excluding a debt for one dwelling which is owned by such corporation or partnership and which a shareholder or partner maintains as a principal residence, unless such debt arises out of a farming operation), on the date the case is filed, arise out of the farming operation owned or operated by such corporation or such partnership; and
   (c) if such corporation issues stock, such stock is not publicly traded.

These debt limits will be increased periodically based on the Consumer Price Index.

Definition of Farming Operation. The term "farming operation" includes farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state.

Definition of Family Fisherman and Monetary Limits. The term "family fisherman" means:

(1) an individual or individual and spouse engaged in a commercial fishing operation;
   (a) whose aggregate debts do not exceed $1,924,550 and not less than 80 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse, unless such debt arises out of a commercial fishing operation), on the date the case is filed, arise out of a commercial fishing operation owned or operated by such individual or such individual and spouse; and

(b) who receive from such commercial fishing operation more than 50 percent of such individual's or such individual's and spouse's gross income for the taxable year preceding the taxable year in which the case concerning such individual or such individual and spouse was filed.

Similar provisions are included for partnerships and corporations. It is interesting to note that the family fisherman definitions and debt structure are more in line with the original family farmer provisions rather than in conformity with the new modifications to the family farmer definitions and debt structure as a result of BAPCPA.

The term "commercial fishing operation" means:

(1) the catching or harvesting of fish, shrimp, lobsters, urchins, seaweed, shellfish or other aquatic species or products of such species; or
(2) aquaculture activities consisting of raising for market any species or product described in subparagraph (1).

"Commercial fishing vessel" means a vessel owned by a family to carry out a commercial fishing operation.

Commencement of the Chapter 12 Case

Chapter 12 is commenced by the filing of a voluntary petition for relief with the bankruptcy court and the payment of the requisite filing fee. An individual, referred to as the standing trustee, is appointed in each Chapter 12 to act as the disbursing agent for payments under the plan. The trustee is paid a fee from the payments to creditors.

The Plan

In order to accelerate the operation of Chapter 12, the Code requires that a Chapter 12 plan be filed no more than 90 days after the filing of the petition for relief. While the court can extend that 90-day deadline, the extension generally occurs only if there is substantial progress toward the formulation of a plan. The extension of the deadline is the exception rather than the rule. Only the debtor may file a plan.

Like a Chapter 11 plan, a Chapter 12 plan must classify creditors and provide for their treatment. Compared to most Chapter 11 plans, Chapter 12 plans are relatively simple and straightforward with a single unsecured class and separate classes for each secured creditor. The creditor should carefully review the classification and treatment of the claim under the plan.

Filing a Proof of Claim

All creditors must file a proof of claim, irrespective of being scheduled by the debtor. The proof of claim must be filed not later than 90 days after the first date for the meeting of creditors as initially set by the court or the office of the United States Trustee. Other than as contained in the notice of the meeting of creditors, there may be no other notice to creditors warning creditors of the deadline for the filing of proofs of claim.

A Trade Creditor's Primary Concerns about Chapter 12 Confirmation

The requirements for confirmation of a Chapter 12 plan are similar to those in a Chapter 11 proceeding, but with some specific distinctions. Among the requisites for plan confirmation is that the amount to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate were liquidated under Chapter 7. Further, the debtor must show that it will be able to make all payments under the plan and comply with all other provisions of the plan.

A trade creditor may object to confirmation of a Chapter 12 plan. If a trade creditor or the trustee objects, then the debtor can only confirm a plan if:

(1) the value of the property to be distributed under the plan on account of such objecting creditor is not less than the amount of the claim;

(2) the plan provides that all of the debtor's projected disposable income to be received in a three-year period (or longer period if approved by the court) will be applied to make payments under the plan; or

(3) the value of the property to be distributed under the plan in the three-year period (or longer period if approved by the court) is not less than the debtor's disposable income for that period.

Discharge

A Chapter 12 debtor will be granted a discharge only after all amounts payable under the plan have been made. The court will not grant a discharge if there is pending any proceeding in which the debtor may be found guilty of specific felonies or liable for specific debts defined in Section 522(q) of the Bankruptcy Code.

BASICS OF CHAPTER 13

Overview

Chapter 13 is denominated "Adjustments of Debts of an Individual with Regular Income" and affords a means of reorganizing the debts of an individual who has regular income from one or more sources, regardless of employment. From a trade creditor's point of view, the likelihood that a trade creditor may become involved in many Chapter 13s increased when Congress raised the debt limits from $100,000 in unsecured debt and $300,000 in secured debt to an increasing scale of debts, subject to periodic adjustment. Currently, the debt limits are $394,725 for unsecured debts and $1,184,200 for secured debts. Chapter 13 affords an individual employee, a professional or a business owner an opportunity to reorganize debts through a plan that classifies and provides for treatment of claims. As in a reorganization case, a creditor's primary concern will be monitoring the filing and provisions of the plan for repayment and discharge of the indebtedness

Eligibility

The Bankruptcy Code places three limitations on eligibility for relief under Chapter 13. First, a debtor must be an *individual*; thus, partnerships, corporations and other business entities are not eligible for Chapter 13 relief. Second, the individual must have regular income. The income may be derived from such varied sources as wages, the operation of a business, or may come from Social Security or welfare. Finally, the debtor's indebtedness may not exceed the secured debt and unsecured debt limits as they are periodically adjusted. The first two tests are rarely at issue: (1) whether or not the debtor is an individual; and (2) whether or not the income is sufficiently regular to qualify. If a debt is genuinely contingent or disputed, it is not included in the calculation of the debt total subject to the limit. Debtors, however, often overlook the unsecured portion of a secured claim. For example, if a debtor's homestead has a value of $300,000, but has a $600,000 mortgage against it, there is a $300,000 secured claim and a $300,000 unsecured claim, both held by the mortgagee. Overlooking the unsecured portion of the mortgagee's claim may lead to miscalculating the debt total and may render the debtor ineligible.

Generally, the standing trustee appointed to administer the case will raise the issue of the debt limits or computations.

Summary of a Typical Case

A typical case is commenced by the filing of a Chapter 13 petition with the bankruptcy court in the district in which the debtor resides and the payment of the requisite filing fee. The debtor must file a plan for dealing with the debts with the petition. However, if no plan is filed with the petition, the debtor is given 15 days to file a plan. Failure to file a plan by the 15-day deadline will subject the Chapter 13 debtor to a motion to dismiss its petition.

Upon filing, the case is referred to the standing trustee, who is appointed by the United States Trustee to handle Chapter 13s in a particular location. The standing trustee's responsibilities are primarily to collect the money paid in by the debtor and disburse it to creditors in accordance with a confirmed plan. The trustee is paid a percentage, established by the United States Trustee, of the disbursements to creditors. The fee, however, may not exceed five percent of disbursements. A standing trustee should be able to answer questions about the status of the case and provide the creditor with a summary of any payments and other disbursements made by the trustee. The standing trustee presides at the §341 meeting in Chapter 13 cases and generally makes recommendations to the court concerning confirmation. Rarely will the court confirm a plan if the trustee opposes it.

The standing trustee is also responsible for objecting to claims and other administrative aspects of the case and, on occasion, may bring preference or lien avoidance actions where appropriate.

Filing a Proof of Claim

All creditors must file a proof of claim, irrespective of being scheduled by the debtor. The proof of claim must be filed not later than 90 days after the first date for the meeting of creditors as initially set by the court or the office of the United States Trustee. Other than as contained in the notice of the meeting of creditors, there may be no other notice to creditors warning creditors of the deadline for the filing of proofs of claim.

The Plan

Generally, a plan is filed with the petition for relief under Chapter 13. If the debtor fails to file a plan, the standing trustee will move to dismiss the case.

As in Chapter 11, the plan must classify creditors and provide for their treatment. The rules on classification and treatment of creditors that apply in Chapter 11 also apply in Chapter 13. Although the rules for a Chapter 13 plan are less complicated than those in Chapter 11, there are specific requirements with respect to the length of payments under a Chapter 13 plan and with respect to an in-depth examination into the Chapter 13 debtor's current monthly income.

A typical Chapter 13 plan will provide for one or two classes of secured creditors, usually the mortgage on the debtor's homestead and the security interest on the debtor's vehicle. Chapter 13 specifically permits the debtor to provide special treatment for certain consumer claims secured by guarantees of relatives. The plan may also provide for a special class of creditors whose continued cooperation is essential to the performance of the Chapter 13 plan.

Since a Chapter 13 plan may provide for the cure of any *monetary* default on a homestead mortgage or other secured debt, Chapter 13 is particularly useful in those states which have creditor-oriented foreclosure systems permitting the creditor to sell the homestead or other property on very short notice. However, any default must be cured within a "reasonable" period of time. Thus, if the debtor is six months delinquent on house payments, the court will generally require that the default be cured within six months to one year. The typical Chapter 13 plan will also provide for payments to the creditor for both the pre-petition default and for post-petition payments under the contract. If the creditor has already repossessed the collateral, the bankruptcy court can order the property turned over to the debtor in return for payments under the Chapter 13 plan.

With the new criteria for determining the debtor's disposable income under BAPCPA, it is more likely that unsecured creditors will receive distributions in a Chapter 13 proceeding, especially where the debtor is a business owner.

Chapter 13 sets forth substantial requirements for what must be included in the Chapter 13 plan and additional requirements for those things that may be included in the Chapter 13 plan.

Among other things, the Chapter 13 plan must provide for the submission of all of the debtor's future earnings or future income to the supervision and control of the trustee as is necessary for the execution of the plan. The plan must provide either for full payment to all priority claims or—if less than full payment is proposed—the debtor must contribute all its disposable income for a five-year period in order to make its payments under the plan.

BAPCPA sets forth criteria, based on the current monthly income of the debtor and the debtor's spouse, for the court to determine whether the debtor will be provided with three years to pay its debts or whether the debtor will be permitted five years to pay its debts.

BAPCPA has also imposed special notice provisions that a Chapter 13 trustee must give to any holder of a claim for a domestic support obligation so that full information and protection is provided to the holder of such claim.

A creditor must file a claim in a Chapter 13 case to participate in any distribution under the plan. A debtor will get a windfall if creditors fail to file claims. However, the creditors who do file claims may be paid more of their allowed claim if the debtor is making a fixed monthly payment to the trustee for distribution *pro rata* among creditors.

Confirmation

The court must hold a confirmation hearing on the plan and any creditor may object to confirmation. The hearing on confirmation may be held not earlier than 20 days and not later than 45 days after the meeting of creditors under Section 341(a), unless the court determines that it would be in the best interests of the creditors and the estate to hold such hearing at an earlier date and there is no objection to such earlier date.

There are nine requirements of a Chapter 13 plan. A review by the creditor with its counsel should be made of the complete details of these nine requirements when the creditor is faced with a Chapter 13 confirmation hearing. Succinctly stated, the nine requirements are:

1. The plan complies with the Chapter 13 provisions and all other provisions of the Bankruptcy Code.
2. Any fee, charge or amount required has been paid.
3. The plan has been proposed in good faith and not by any means forbidden by law.
4. The value, as of the effective date of the plan, of property to be distributed to each allowed unsecured claim is not less than such claim would receive in a Chapter 7 liquidation.
5. With respect to each allowed secured claim, the holder of that secured claim has accepted the plan, retains the lien securing the claim until payment of the debt or discharge, or if the case is dismissed or converted, the secured claim retains the lien. There are additional provisions for secured claims.
6. The debtor will be able to make all its plan payments.
7. The Chapter 13 petition was filed in good faith.
8. All domestic support obligations that arose after the filing of the Chapter 13 petition have been paid.
9. All applicable federal, state and local tax returns have been filed.

If an unsecured claimant objects to confirmation, the court may not approve the plan unless:

(1) the value of property to be distributed under the plan is not less than the amount of such claim; or

(2) the plan provides that all of the debtor's projected disposable income to be received during the applicable commitment period of the plan will be applied to make payments to unsecured creditors under the plan.

There are further details to these requirements that should be reviewed by a creditor with its counsel if involved in a Chapter 13 proceeding.

Scope of Discharge

The discharge in Chapter 13 is granted only after the debtor has completed all payments required under the plan. The court may grant a discharge before all plan payments are made only if the failure to complete payments is due to circumstances beyond the control of the debtor and each unsecured

claim has received what they would have gotten in a Chapter 7 liquidation, and it is not practicable to modify the Chapter 13 plan.

In addition the court shall not grant a discharge if the Chapter 13 debtor has received a discharge:

(1) in a case filed under Chapter 7, 11 or 12 of the Bankruptcy Code during the four-year period preceding the date of the order for relief under Chapter 13; or

(2) in a case filed under Chapter 13 of the Bankruptcy Code during the two-year period preceding the date of such order for relief.

Further, in order to receive a discharge, the Chapter 13 debtor must complete an instructional course concerning personal financial management (unless the United States Trustee or bankruptcy administrator determines that no such course in their district is adequate).

Finally, the court may not grant a discharge unless notice and a hearing is held if there is reasonable cause to believe that the debtor may be found guilty of certain felonies.

A BRIEF OVERVIEW OF CHAPTER 9

Chapter 9 applies to financially distressed municipalities. Municipalities include cities, counties, towns, villages, school districts, public hospitals, utilities and school districts.

Unlike a debtor in Chapter 11, a municipality seeking relief under Chapter 9 must satisfy Chapter 9's eligibility requirements. Municipalities that seek Chapter 9 relief must be authorized under state law to file for Chapter 9, must be insolvent and must act in good faith. A municipality debtor is insolvent if it either is generally not paying debts, not subject to *bona fide* dispute, as they come due at the time of the bankruptcy filing, or is unable to pay debts as they come due in the near future. A municipality satisfies the good faith requirement by proving any of the following: (1) an agreement with the requisite majority of impaired creditors under any plan; (2) an inability to reach an agreement with a majority of impaired creditors after good faith negotiations; (3) negotiations with creditors are impracticable; or (4) a reasonable belief that a creditor is attempting to obtain a preference. The municipality must also prove that it is seeking a plan of adjustment of its creditors' claims.

Much of the litigation in Chapter 9 has centered on the municipality debtor's eligibility for Chapter 9 protection. Detroit (the largest municipality to file for bankruptcy both in terms of population and total debt of approximately $18 billion) was found to be an eligible Chapter 9 debtor after litigating its authorization to file for Chapter 9 relief under Michigan law, as well as the good faith filing and insolvency requirements. Stockton, California was also found to be eligible for Chapter 9 relief after pursuing a pre-petition mediation process required under California law and satisfying the insolvency and good faith filing requirements. San Bernardino, California was also found to be an eligible Chapter 9 debtor by declaring a "fiscal emergency," which satisfied a California requirement for eligibility for Chapter 9, and also satisfying the good faith filing and insolvency requirements.

Municipalities have not had an easy time satisfying Chapter 9's eligibility requirements. As a result, many Chapter 9 cases have been dismissed. For example, the Chapter 9 petition of Harrisburg, Pennsylvania was dismissed because Harrisburg was not authorized to file for Chapter 9 relief under Pennsylvania law. The Chapter 9 petitions filed by Boise, Idaho and Bridgeport, Connecticut were dismissed because the debtor could not satisfy the insolvency requirement.

A bankruptcy court has limited powers in a Chapter 9 case. The court has the power to determine whether a municipality is eligible for Chapter 9 relief, whether to approve the assumption or rejection of executory contracts and leases, whether to approve a Chapter 9 plan, and whether to dismiss a Chapter 9 case. The court cannot interfere with any of the debtor's political or governmental powers, the debtor's property or revenues, or the debtor's use or enjoyment of income-producing property. The court also has no power to take over a municipality's operations, remove municipal officials, or direct the municipality to appoint a trustee or receiver.

A municipality also does not need court approval to use, sell or lease property outside of the ordinary course of business. That means a municipality can pay pre-petition trade claims without obtaining court approval, which Detroit has done.

An automatic stay arises when a municipality files for Chapter 9. A municipality must file a list of creditors, but does not have to file schedules or a statement of financial affairs, unless the bankruptcy court directs otherwise.

The rules for filing a proof of claim are the same as the rules in Chapter 11 cases. Creditors should file a proof of claim prior to the deadline set by the court.

A municipality's goal in a Chapter 9 case is to obtain approval of a plan of adjustment that can provide for a reduction and/or stretch out payment of creditors' claims. Only the municipality can file a plan. Once it satisfies all of the requirements for approval of a plan, the municipality receives a discharge of most of its indebtedness that is replaced by the obligations contained in the plan. Jefferson County, Alabama, the second largest municipality to file a Chapter 9 (in terms of population and total debt of approximately $4.1 billion) obtained court approval of its plan of adjustment on November 22, 2013. Detroit also obtained court approval of its plan of adjustment.

Neither the municipality nor any creditor can seek to convert the Chapter 9 case to a case under another chapter of the Bankruptcy Code. A creditor's sole recourse is to seek dismissal of a Chapter 9 case. The grounds for dismissal include: (1) the municipality's failure to satisfy any of Chapter 9's eligibility requirements; (2) the municipality's unreasonable delay in pursuing a plan; (3) the municipality's failure to propose or obtain approval of a plan within the time fixed by the court; (4) the court's refusal to approve a plan and grant the municipality any additional time to modify its plan or file a new plan; (5) the municipality's material default under an approved plan; or (6) the termination of any approved plan.

ESTABLISHING A SYSTEMATIC RESPONSE TO BANKRUPTCY FILINGS

Notice Provision

Section 342 of the Bankruptcy Code contains an expanded notice requirement a debtor has to satisfy in order for the notice to be effective against its creditors. Any notice the debtor is required to provide must contain the name, address and last four digits of the debtor's taxpayer identification number. Any notice that relates to an amendment of the debtor's schedules to add a creditor must contain the debtor's full taxpayer identification number.

Also, where a creditor sends at least two communications to the debtor, containing the debtor's account number and the address at which the creditor wants to receive correspondence from the debtor, within 90 days before the debtor's bankruptcy filing, the debtor is required to send notices containing the debtor's account number to the creditor at the specified address. Any non-complying notice will not be effective until it is brought to the creditor's attention. Where the creditor has established reasonable internal procedures for dealing with bankruptcy notices, the debtor's notice will not be deemed to have been brought to the creditor's attention until receipt by the person in or subdivision designated in the creditor's procedures to receive notice.

A creditor will not be penalized for violating the automatic stay for conduct prior to the creditor's receipt of effective notice of the bankruptcy in accordance with the above-described procedures.

Internal Routing of Bankruptcy Notices

Bankruptcy often involves a number of deadlines for the taking of action or the filing of objections. For example, if a Chapter 11 debtor in possession seeks to sell assets other than in the ordinary course of business, notice must be given to creditors who are given an opportunity to object. If no timely objections are filed, the debtor may go ahead with the sale without further notice.

It is absolutely essential, therefore, for the creditor to establish an internal routing system for handling all bankruptcy notices that will get them to the proper decision maker in time to file objections or otherwise respond.

Receipt and Routing of Notices

An internal response system should get the notice from the bankruptcy court matched up with the appropriate file and to the decision maker as soon as possible. Because many of the deadlines are

relatively short, the creditor may need to file a change of address form with the bankruptcy court and give notice to the debtor or trustee if notices are being mailed to a lockbox or other office where rerouting may involve unnecessary delay.

Copies should be routed to the creditor's sales department with instructions on the effect of the bankruptcy filing on existing credit limits and any need for consultation on post-petition sales. There have been situations in which the credit department of a particular creditor is opposing the debtor in the bankruptcy court while the sales department, apparently unaware of the bankruptcy filing, is selling goods to the debtor post-petition on credit. Special instructions should, therefore, be prepared on dealing with bankruptcy notices and routing them to all departments that may be affected by the bankruptcy filing.

The credit manager, or other officer that makes decisions on bankruptcy cases, must receive the notice as soon as possible and note deadlines for the meeting of creditors: (1) the filing of a proof of claim; (2) any objections to sales of assets, use of cash collateral, etc.; and (3) the date of any organizational meeting for the formation of a creditors' committee and for the deadline for submitting the form to be appointed to a committee.

A separate system should be established to deal with adversary proceedings, which are lawsuits filed within a bankruptcy case, because the debtor or some other party in the bankruptcy case could sue the creditor's company. These will almost always involve reference to counsel. Most adversary proceedings will require the filing of an answer within a specified period of time after service and, therefore, require prompt handling. Since an adversary proceeding may be served by mail or in person, special instructions for routing any legal documents mailed or personally served on the company should be established.

While a creditor's particular response to a bankruptcy filing will vary according to the location of the filing, the amount of the claim and any post-petition relationship with the debtor, the creditor should prepare specific written policies on reviewing existing credit lines, reviewing goods in transit and reviewing any other relationships with the debtor in bankruptcy. In particular, the creditor will need to review what actions it can take to recover or reclaim goods in transit or recently delivered to the debtor on credit terms. (*See* Chapter 1 discussion of UCC 2-702 and 11 U.S.C.§546 and the rights of reclaiming sellers in *Volume IV*.)

Education of Sales and Other Contact Personnel

The creditor's bankruptcy system should include a periodic review with sales and other staff members who have direct contact with a customer to remind them of the need to watch for bankruptcy danger signs and what actions to take upon learning of the bankruptcy filing. While the credit department will, of course, develop its own early warning system for anticipating potential bankruptcy problems, sales and other contact staff people may prove invaluable in avoiding losses. They should, however, be given at least a rudimentary knowledge of the bankruptcy process and, in particular, any limits placed on post-petition credit sales to the debtor.

Alerting Lockbox Users

If a creditor is using a lockbox system to handle receivables, it may be the only address that the debtor has to mail a notice. Thus, it is imperative for the creditor to establish procedures for the staff that deals with receipts at the lockbox address for handling bankruptcy notices. The staff should contact the proper person *immediately* by phone or fax upon receipt of any bankruptcy notices so that action can be taken to protect the company's position and to be sure to not run afoul of the automatic stay. If the bankruptcy court has been given the lockbox address as the mailing address, the creditor should immediately file a change of address with the court and with the debtor or trustee so that notices will be routed directly to decision makers.

FILING A PROOF OF CLAIM

Need for Filing

In cases under Chapters 7, 12 and 13, the filing of a proof of claim is required to participate in any distribution of the bankruptcy estate assets to unsecured creditors. A claim is deemed allowed once it is filed unless the trustee, the debtor in possession or someone else granted standing under the Bankruptcy Code objects to it.

In a Chapter 11 case, a claim is *deemed* to be filed for any claim or interest that the debtor correctly lists in the schedules without indicating that the claim is disputed, contingent or unliquidated. (11 U.S.C. §1111(a)). To determine whether it will be necessary to file a proof of claim in a Chapter 11 case, the creditor should carefully review the debtor's listing of the claim in the schedules. If the amount listed is incorrect or the claim is listed as disputed, contingent or unliquidated, the creditor *must* file a proof of claim. If a creditor files a proof of claim in a Chapter 11 case and the claim is scheduled, the filed claim will simply supersede the scheduled claim. (Fed. R. Bankr. P. 3003(c)(4)). Before filing a proof of claim, a creditor should discuss the case with counsel as filing a claim may subject the creditor to the jurisdiction of the bankruptcy court and waive any right the creditor has to a jury trial on any claim the debtor may make against the creditor.

Section §506 of the Code determines whether a claim is to be treated as a secured claim and if so, to what extent. If a creditor has a lien on the debtor's property, the creditor has a secured claim up to the value of the collateral. For example, if the creditor has a claim for $10,000 and the value of the inventory securing the debt is worth $15,000, the creditor has a fully secured claim. If, on the other hand, the claim is for $10,000 and the collateral is worth only $7,500, the secured claim is for $7,500. The remaining $2,500 is an unsecured claim.

Terminology

Technically, any document filed with the bankruptcy court that is intended to set forth the creditor's rights to payment of a debt may be considered proof of claim. The document is often simply referred to as a "claim." While some courts have recognized "informal" claims such as letters to the court, the creditor should timely file a proof of claim on the official form to avoid problems.

Deadlines

To be effective, the creditor's proof of claim must be timely filed with the appropriate bankruptcy court or claims agent if approved by the bankruptcy court. Federal Rules of Bankruptcy Procedure Rule 3002 establishes the deadlines for the filing of all claims under Chapters 7, 11, 12 and 13. To be considered in a Chapter 7, 11, 12 or 13 case, the proof of claim must be received by the court in which the bankruptcy case is pending or claims agent, if applicable, on or before the last day for filing claims. Actual receipt is essential; merely mailing it to the court or claims agent before the date will not suffice. The original notice of the bankruptcy filing might either provide for the deadline to file a proof of claim, or state that a deadline will be set at a later date. Unless the court establishes other deadlines, the Federal Rules of Bankruptcy Procedure establish the following:

CHAPTER 7

Federal Rules of Bankruptcy Procedures Rule 3002 provides that all claims must be filed within 90 days of the first date set for the §341 meeting. However, the initial Notice of Commencement, the document that advises the creditor of the filing of the bankruptcy case, will often instruct the creditor *not* to file a proof of claim until the court advises otherwise. This is because so few Chapter 7 cases result in any distribution to creditors. If the trustee discovers that there are assets available for distribution, the creditor will receive instructions to file a proof of claim along with the deadline for doing so.

CHAPTER 11

Federal Rule of Bankruptcy Procedure Rule 3003(c) grants the bankruptcy court the authority to establish a deadline for filing claims. In some districts, it is customary for the deadline to be

established immediately upon the filing of the petition. In other districts, the court will approve any deadline. The creditor should review all notices.

Chapter 12

As in Chapter 7, Rule 3002(c) provides that all claims must be filed within 90 days of the first date set for the §341 meeting.

Chapter 13

All proofs of claim must be filed within 90 days after the first date set for the §341 meeting. Again, the deadline is determined by the original date of the §341 meeting and will not be extended should the §341 meeting be rescheduled.

Calculation of Time and Extensions

As stated earlier, the 90 days are calculated from the date the §341 meeting was initially scheduled and include all calendar days including holidays, Saturdays and Sundays. However, if the 90th day falls on a holiday or weekend day, the next workday is the deadline. For example, if the 90th day after the §341 meeting falls on a Saturday, and the proof of claim form reaches the bankruptcy court by the following Monday, it is timely filed. In a limited number of circumstances in Chapter 11 cases, a late filed claim will be treated as timely if the claim's lateness is due to *excusable neglect*. However, excusable neglect is hard to prove and if the creditor discovers that the deadline is missed, the creditor should consult counsel about whether to file a late claim. The bankruptcy court may extend the deadline for the filing of a proof of claim if a motion requesting the extension is filed *before* the expiration of the original deadline.

Official Proof of Claim Form

Over the last several years, the official bankruptcy forms have been under review with an eye toward simplification and clarification. Official Form 410 should be used to file proofs of claim in all cases. Creditors should make sure they are using the current form. Although it is extremely rare for a court to disallow a proof of claim filed on something other than the official form, a creditor should use the latest form included in the Bankruptcy Rules. (*See* sample of the most recent version of Form 410 at the end of this chapter.)

General Comment

Not all claims need be on official forms. Virtually any writing, which sets out an enforceable claim against the debtor that is served on the trustee or filed with the court, may be deemed an informal claim. Generally, all it must do is set out that the debtor is somehow indebted to the writer. Filing a letter to the court or trustee may suffice, but there is always some risk that the court will disallow the informal claim. The timely use of Official Form 410 is recommended. Official Form 410 is available at any bankruptcy court clerk's office. Additionally, this form can be found online at www.uscourts.gov/FormsAndFees/Forms/BankruptcyForms.aspx. A creditor will then need to go into Part I and select Form 410. If, however, the creditor corresponds with the trustee about the claim but fails to file a formal claim on the official form, the creditor should consult counsel about the possibility that the correspondence constitutes an informal but timely claim.

An official claim form may be obtained from the clerk of the bankruptcy court or any office supply company. Or a computer may be programmed to prepare the form. Any form used should, however, be identical to the official form. Claims should be prepared in duplicate and signed by an officer or attorney of the company. A creditor should also provide additional copies of the proof of claim to the clerk's office or claims agent, if applicable, with a request to return at least one filed stamped copy. The creditor should include a self-addressed, stamped envelope. A proof of claim may be lost or misfiled. Retaining a file stamped copy will eliminate any potential problems if the proof of claim is later missing.

Also the filing of the claim may be confirmed by checking the court docket via PACER.

FILLING OUT FORM 410

Identity of the Bankruptcy Court

In the top left-hand corner of the form, the creditor will fill in the name of the court in which the case is pending. The form reads, "United States Bankruptcy Court _____ District of _____." The notice will identify the court as the "Northern District of Florida" or the "District of Kansas." Some states are divided into more than one district and the district in which the case is filed should be identified. While some districts are further divided into divisions, it is not necessary to identify the division; however, the creditor should be sure to send the proof of claim to the correct office. Note, in some of the larger cases, the court appoints a claims agent. In those instances, the creditor should follow the instructions received as to where to file the claim.

Name of the Debtor

The name of the debtor also in the left-hand corner of the form, should be taken from the bankruptcy notice. Usually, this includes the debtor's full name. It is not necessary to include aliases or d/b/a names. If the court includes a tax identification number in the caption, the creditor should be sure to include it in the proof of claim.

Bankruptcy Case Number

The form also requires the creditor to insert the bankruptcy case number. This number will be set out in the notice received. Given the tremendous number of cases filed, it is imperative that the creditor give the correct number. If the case number is not accurately listed, the proof of claim may be filed in the wrong case and never seen again. Both the debtor's name and the case number should be carefully checked and should appear on all correspondence with the court or the trustee.

Creditor Information

The next portion of Official Form 410 requires the company name and address to be inserted. Where indicated, the creditor will insert the full legal name of the company. Directly below that, the creditor must indicate if it had acquired the claim from a third party and identify that party. The creditor will indicate where the notices are to be sent. If having them sent to the company, the street address or post office box number will be inserted. The address that will deliver further correspondence to the decision maker most quickly should be used. Never use a lockbox if it is controlled by the bank. Someone else can also be designated to receive notices, such as the attorney, in this box, but the creditor should be sure to include that person's name. In the space provided, the telephone number of the person designated to receive notices or be responsible for the file should be inserted.

Also, make sure to insert the address where payments are to be made if different. The claim form requesting creditor information also asks whether the claim is an amendment of a claim previously filed. For example, if the previously filed claim lists collateral, and that collateral is now recovered and liquidated, the creditor should check the box stating that this is an amended claim. If amending a claim because the amount due has been adjusted, that information should be provided. This may require obtaining a copy of the earlier claim. The form also requests the claim number and the date on which the original claim was filed.

The next box asks if anyone else filed a proof of claim relating to the claim. If checking this box, the creditor must provide a copy of the claim or a statement giving the particulars.

Claim Information

- Insert the claim number the creditor uses to identify the debtor. Then insert the amount of the claim on the bankruptcy filing date.
- The form asks to indicate the basis for the claim. Examples include: (1) goods sold; (2) services performed; (3) money loaned; (4) personal injury/wrongful death; (5) car loan; (6) mortgage note;

or (7) credit card. The creditor should briefly describe the legal basis for the claim against the debtor in the blank provided.

- The next section inquires whether there is a security interest in property of the debtor. This section includes a choice of boxes identifying the collateral as real estate, motor vehicles or other collateral. It also requests the value of the collateral, the interest rate, the arrearage owing on the bankruptcy filing date, the amount of the secured and unsecured claim and the basis for perfection (e.g., security agreement, UCC filing). If the value of the collateral securing the loan is greater than the amount of the claim, this is a fully secured claim and may be entitled to include post-petition interest and fees as part of the claim. If, on the other hand, the value of the collateral securing the claim is worth less than the amount of the claim, the claim will be a secured claim only up to the value of the collateral. The remainder of the claim will be an unsecured, nonpriority claim. For example, if the claim is $10,000, but the collateral is only worth $7,000, this is a secured claim for $7,000 and an unsecured, nonpriority claim for $3,000. In determining the amount of the claim the creditor should be sure to deduct any precomputed interest.
- The next sections deal with whether the claim is based on a lease and whether the creditor has setoff rights. Finally, the proof of claim specifies claims entitled to priority under 11 U.S.C. §507. The Bankruptcy Code gives certain types of unsecured claims a priority over others. These claims include domestic support obligations; wages, salaries or commissions currently up to $12,850 per claimant; contributions to employee benefit plans, subject to a specified cap, up to $12,850 per employee; $2,850 of customer deposit claims; and taxes. (11 U.S.C. §507). If the creditor is asserting a claim for the new "20-day" administrative claim allowed under §503(b)(9) and wishes to include it in the proof of claim, before requesting a hearing on notice, as will be required in order to have the §503(b)(9) claim allowed and/or paid, then the creditor should identify and itemize that claim in the section marked "other." However, this may not be the appropriate way to assert a Section 503(b)(9) priority claim (*See* Chapter 1 – Reclamation, Stoppage in Transit and Adequate Assurance Rights, Administrative Claim in Favor of Goods Suppliers, and Other Return of Goods Remedies in *Volume IV*). All other types of unsecured claims are nonpriority, unsecured claims. Except for the §503(b)(9) priority for "20-day" goods, rarely will a trade claim be entitled to priority.
- It is also imperative to attach copies, not the originals, of all supporting documentation to the proof of claim. These copies must be legible and clear and attached to all copies of the proof of claim filed with the court. If the documentation is voluminous, a summary of the documentation may be provided. For example, if the claim consists of thousands of open invoices, a statement of account or a computer printout of an aging history may be attached. The creditor should maintain every document that substantiates the claim as it will have to be provided at some point in the future. Failure to provide legible copies might result in the trustee or the debtor in possession challenging the claim. By providing the necessary documentation, it can save the time and money needed to defend a challenge to the claim. It can also explain why supporting documents are not available.
- The creditor should also enclose a stamped, self-addressed envelope and copy of the claim in order to receive an acknowledgment of the filing of said claim. A creditor should check the local rules for the district in which the case is pending for any special rules on filing claims.

To protect against the misfiling of the original, the creditor should provide the court with at least one extra copy of the proof of claim with a self-addressed, stamped envelope and ask the court to return a file stamped "copy."

Electronic Filing

The creditor should also check with the court on whether electronic filing of the claim is required. Some courts, which have resorted to electronic claims filing, specifically say not to attach more than a specified number of pages to the claim. Electronic filing always requires the claim and supporting documents to be converted to a PDF (portable document format) file.

Certification

At the end of the claim, the creditor should be sure to sign and add a title. Also the signature must be dated. If for some reason the creditor is signing under a power of attorney, a copy of that power of attorney must be attached.

OBJECTIONS TO PROOFS OF CLAIMS

General Comment

A trustee in bankruptcy in Chapters 7, 11 and 13, and the debtor in possession under Chapter 11 are statutorily responsible for reviewing claims, to determine whether the claims are proper claims against the estate. A properly executed and filed claim is *prima facie* evidence of the validity and amount of the claim. (Fed. R. Bankr. P. 3001(f)).

Objections range from a simple objection on the grounds that the claim lacks the necessary documentation to prove the claim. By far the most common objections are based on a lack of documentation or an assertion that, based on the documentation provided, the debtor is not liable for the claim. These objections are often simply communication problems, and providing the trustee or debtor in possession with the requested documentation will resolve the matter. Failing to attach the required documents to the proof of claim will almost guarantee such an objection.

Another routine objection involves the inclusion of precomputed interest or post-petition interest in a claim. For example, the debtor files bankruptcy on January 1, but the proof of claim indicates that interest is computed through February 1, the date the claim was filed. Post-petition interest is generally not allowed and almost never on unsecured claims. Therefore, if the claim includes interest accrued after the bankruptcy case was filed, an objection will likely be made. Failure to timely file the proof of claim will certainly result in an objection that will be sustained, unless in a Chapter 11 case the claim is scheduled in the correct amount and not listed in the debtor's bankruptcy schedules as disputed, contingent and unliquidated. The creditor's only recourse is to argue lack of notice of the claims deadline or demonstrate excusable neglect in missing the deadline. While many routine objections are usually easily resolved by providing the debtor in possession with the necessary documentation or agreeing upon the last date through which interest will be computed, there is a cost involved. The trustee will charge the estate for all legal expenses incurred in connection with the claim objection. The creditor ultimately pays these expenses because they will reduce the amount available for distribution to unsecured creditors. In effect, the trustee or debtor in possession is fighting the creditor with the creditor's own money. And of course the creditor might have to incur the expense of retaining counsel.

Procedure

The procedures for objecting to claims and resolving those objections vary from court to court. In some courts, the trustee or debtor in possession will file the claims objection, and the court will send a notice for hearing before the court on a specific date of all objections filed in the case. If a creditor fails to appear or send counsel to the scheduled hearing, the court will sustain the objection and disallow the claim in part or in full. In other courts, the trustee or debtor in possession will file notice of the claim objection and specify a deadline for responding with a request for a hearing. Unless a creditor responds by that date and requests a hearing, the court will simply enter an order sustaining the objection and disallowing the claim in full or in part.

On all but the most routine claim objections, the creditor should contact counsel to make sure that the claim is allowed in the proper amount.

DISCHARGE AND DISCHARGEABILITY

Preliminary Comment

A detailed discussion of discharge and dischargeability is beyond the scope of this type of text. The creditor should be aware that the goal of virtually any bankruptcy proceeding is the discharge of some or all of the debtor's debts and obligations. The Bankruptcy Code recognizes that, under certain circumstances, a debtor should be denied a discharge completely in Chapter 7. (11 U.S.C. §727). The bases for denial of discharge generally revolve around fraud, perjury or other misconduct such as concealment of assets or destruction of records in connection with the bankruptcy case itself.

The bases for denial of discharge are generally not major issues in Chapter 11 proceedings. Most major Chapter 11s are filed by corporations, and a corporation does not receive a discharge under Chapter 7. A discharge, however, is granted in Chapter 11, but only to the extent provided in the plan.

The Code also recognizes that certain types of debts should be excepted from the operation of the discharge. (11 U.S.C. §523). These exceptions to discharge are primarily policy statements by the Congress that certain types of debt will not be dealt with in bankruptcy. For example, many types of taxes are not discharged in bankruptcy under Chapter 7. Taxes in a Chapter 11 require special treatment under 11 U.S.C. §1129(d). Thus, while taxes may not be dischargeable in a typical Chapter 7, they must be dealt with and generally paid in full in the Chapter 11. Likewise, alimony, child support and maintenance awards by the state courts are generally nondischargeable in bankruptcy, as are debts obtained through fraud or the use of a false financial statement, breaches of fiduciary duty by a fiduciary, certain types of student loans, judgments arising out of accidents where the person at fault was driving while intoxicated, and judgments arising out of certain intentional torts and the conversion of collateral. Again, many of these exceptions simply do not arise in Chapter 11 cases. The following discussion will focus primarily on false financial statements and the conversion of collateral.

Before filing a complaint under 11 U.S.C. §727 in any case, a creditor should consider the effect. If the court denies the discharge under that section, no debts are discharged and all creditors are free to pursue their claims against the debtor and the debtor's assets. Then paying the cost of the legal work without any guarantee of either recovery on the claim or recovery of the costs of the 11 U.S.C. §727 complaint may occur. Generally, the creditor will be far better off to pursue a claim that the creditor's debt should be excepted from discharge under 11 U.S.C. §523.

DENIAL OF DISCHARGE UNDER 11 U.S.C. §727

General Background

In order to bar the granting of a discharge in a Chapter 7, a creditor or the trustee must file an adversary complaint alleging one or more of the bases listed in 11 U.S.C. §727. If the court sustains the complaint, the debtor is not discharged even though the trustee may proceed with administration of the estate. In a very general way, the bases listed in 11 U.S.C. §727 involve misconduct or fraud in connection with the bankruptcy case. These bases have relatively little application in Chapter 11 since rather than denying the debtor a general discharge, the court will refuse to confirm a plan.

§727 Checklist

Corporations Not Discharged

Under 11 U.S.C. §727, the bankruptcy discharge in Chapter 7 is given to individual debtors only. Congress, in enacting 11 U.S.C. §727, concluded that the grant of a discharge to a corporate or limited liability entity was inappropriate. Since the 11 U.S.C. §1141 discharge is applicable to individuals and other entities, §727 is of relatively little importance. Note, however, that a corporation or limited liability entity can receive a discharge in Chapter 11. The misconduct necessary to deny a discharge would also support the appointment of a trustee.

Concealing Assets

Pursuant to 11 U.S.C. §727(a)(2), any attempt to transfer or conceal assets prior to the bankruptcy can afford the basis for denial of a discharge. A creditor seeking to bar the discharge under this subsection must prove that the debtor intended to defraud creditors or the bankruptcy trustee in making the transfer. This generally involves gratuitous transfers to family members or other insiders on the eve of bankruptcy. The transfer may take the form of an outright gift of property or the creation of a mortgage on property for which the debtor received insufficient consideration.

Failure to Keep Records

In order to obtain a discharge in bankruptcy, an individual debtor must maintain necessary business records from which the court can determine how the debtor has conducted his or her business.

Where the debtor does not maintain appropriate records or destroys the records on the eve of the bankruptcy or after the filing of the bankruptcy, the court may deny the discharge under 11 U.S.C. §727(a)(3).

PERJURY IN CONNECTION WITH THE BANKRUPTCY CASE

The integrity of the bankruptcy system requires that the courts actively discourage perjury, bribery and failure to obey court orders in connection with the bankruptcy case. An attempt by the debtor to bribe the trustee or other bankruptcy official or outright failure to surrender assets together with perjury in connection with the case may result in the denial of a discharge. (11 U.S.C. §727(a)(4)). Perjury and attempted bribery, of course, are also federal criminal offenses. Also keep in mind that the debtor swears to the accuracy of the information contained in the schedules and statement of financial affairs. Failure to be fully candid in supplying information required in these documents may give rise to an action to deny the discharge because, if the debtor acted intentionally, it amounts to a false statement under oath.

FAILURE TO EXPLAIN DISPOSITION OF ASSETS

One of the primary purposes of a bankruptcy proceeding is to ensure equitable distribution of unencumbered assets to unsecured creditors. Initially, the creditor must prove that the debtor had assets pre-petition that have not been accounted for. The debtor must then be able to account for those assets that existed pre-petition. The debtor must be able to explain what has happened to the assets and their disposition. Under 11 U.S.C. §727(a)(5), the court may deny discharge to a debtor who cannot satisfactorily explain the disposition of assets the creditor has proven were in existence before the bankruptcy was filed.

FAILURE TO OBEY COURT ORDERS OR REFUSAL TO TESTIFY

Naturally, the bankruptcy court is concerned that its orders be obeyed. Thus, if a debtor refuses to obey a court order or refuses to testify upon being granted immunity against self-incrimination, the court may deny a discharge under 11 U.S.C. §727(a)(6). This generally arises if the debtor refuses to testify concerning transfers of property. Immunity must be obtained from the appropriate federal authorities before the debtor can be found to have refused to testify.

PRIOR BANKRUPTCY PROCEEDINGS

A debtor may only file a Chapter 7 petition and obtain a discharge in bankruptcy at eight-year intervals. A bankruptcy case commenced less than eight years after the granting of a previous bankruptcy discharge, is a basis for denying discharge Generally, of course, the court will dismiss the second Chapter 7 proceeding. The bar, however, does not apply to the filing of Chapter 11, 12 or 13 cases after a discharge in bankruptcy in Chapter 7. Since a Chapter 7 discharge is not available to corporations and limited liability companies, this provision applies only to individuals. Note that the eight-year period runs from the date the original discharge was granted through the date of the filing of the second Chapter 7 petition. Generally, in Chapter 7 cases the discharge is granted approximately six months after the petition for relief.

BAPCPA PROVISIONS

A discharge will not be granted if a debtor fails to complete an instructional course concerning personal financial management, unless the United States Trustee or bankruptcy administrator determines that no course in their district is adequate.

Further, a discharge will not be granted if, after notice and a hearing, the court determines that there is or may have been a felony as described in Section 522(q) committed by the debtor.

WAIVER OF DISCHARGE

An individual debtor may voluntarily waive a discharge if the court approves. (11 U.S.C. §727(a)(10)). The waiver is not valid unless it was executed with court approval after the filing of the petition for relief.

Revocation of Discharge

A court has the power to revoke any discharge obtained through the fraud of the debtor if the creditor seeking the revocation did not know of such fraud when the discharge was originally granted. Further, a discharge will be revoked if the debtor knowingly and fraudulently failed to report property that the debtor acquired and which should have become property of the estate. Finally, failure of the debtor to explain satisfactorily a material misstatement in an audit referred to in Section 586(f) of title 28, or failure to make all necessary accounts, papers, documents, etc., which are requested in such audit, will result in a revocation of discharge.

These additions related to financial misstatements were clearly added as a result of various financial and securities frauds that took place during the last several years.

DEBTS EXCEPTED FROM DISCHARGE UNDER 11 U.S.C. §523

General Background

Certain debts are excepted from the discharge, but only upon the filing of an adversary proceeding and action by the bankruptcy court. (11 U.S.C. §523). A very limited number of debts, including taxes, alimony, child support and some student loans, are automatically excepted from discharge unless the debtor seeks a specific determination of dischargeability. The creditor will, of course, be primarily concerned with those types of debt excepted from discharge upon action by the creditor and the court. A trade creditor will be primarily concerned with credit obtained through a false financial statement and conversion of collateral.

§523 Checklist

Taxes

Taxes due less than three years before filing of bankruptcy are not discharged in bankruptcy. (11 U.S.C. §523(a)(1)). In a Chapter 11 case this often leads to the debtor creating a special class for the payment of tax liabilities that would not otherwise be discharged. Occasionally, the tax authorities have acted promptly and secured a lien on the debtor's property through tax assessments. Taxes subject to liens are treated as secured claims. The treatment of otherwise nondischargeable taxes may be of some importance if the creditor, as a member of a committee, is proposing a plan of reorganization.

Credit Obtained by False Financial Statement or Fraud

Since the discharge is intended only for the honest debtor, the bankruptcy code specifically excepts an individual debtor from discharge of debts arising from fraud or the use of a false written financial statement. To bring a claim within this section, the creditor must file a timely complaint to determine dischargeability under 11 U.S.C. §523(a)(2). This section has two separate parts: one relating to fraud and the other relating to the use of a false written financial statement.

The difficulty facing any creditor seeking to bring a claim within the exception provisions of 11 U.S.C. §523(a)(2) is the need to prove the fraud and the fraudulent intent by a preponderance of the evidence. Often, a financial statement is an exercise in creative writing and contains inflated values. While some courts will deny discharge based on inflated values, many will not. It is more likely that the court will except a claim from discharge if the debtor failed to list material obligations or listed assets that the debtor, in fact, did not own.

Unlisted Creditors

The Bankruptcy Code does not discharge the claim of a creditor who is not given notice of the bankruptcy in time to permit the filing of a proof of claim or to file a proceeding to determine the dischargeability of certain types of debts. Only if the creditor actually had knowledge of the bankruptcy case through other means is the debt discharged. Occasionally, a debtor will fail to list a creditor such as credit card company hoping to retain the credit card. That creditor's claim will not

be discharged. Note, however, that in many jurisdictions, the unlisted debt will be discharged if the case is a no asset Chapter 7. These courts reason that the creditor was not denied the opportunity to participate in the distribution of assets because no such distribution was made. In other instances, the court will allow a case to be reopened so that the missing creditor gets listed, and then the discharge applies to that creditor as well.

BREACH OF FIDUCIARY DUTY CLAIMS

Certain obligations arising from fraud or defalcation while acting as a fiduciary, embezzlement or larceny are excepted from discharge. (11 U.S.C. §523(a)(4)). Larceny and embezzlement are fairly easily identified. Breach of fiduciary duty is likewise uncommon. However, secured creditors often assume that there is a trust relationship between a debtor and themselves because of the security agreement. Occasionally, this leads to confusion with the creditor claiming that the debtor has sold property out of trust and, therefore, its claim should be excepted from discharge under 11 U.S.C. §523(a)(4). The majority rule is that a secured claim arising from a security agreement does not involve the necessary type of trust to bring the case within the provisions of 11 U.S.C. §523(a)(4).

INTENTIONAL TORTS/CONVERSION OF COLLATERAL

The Bankruptcy Code provides that debts for the willful and malicious injury by the debtor to another entity or property of another entity are not discharged. (11 U.S.C. §523(a)(6)).

Unless the creditor is making secured loans to a debtor, or leasing property to the debtor, this section will have little impact especially since it is very difficult to win based on a Supreme Court decision requiring proof that the debtor intended the harm that resulted from a willful and malicious act. If the debtor converts property the creditor has leased or in which there is a security interest, it may be a nondischargeable claim. The creditor should consult counsel.

FINES AND PENALTIES/TAXES

Like most taxes, fines and penalties assessed for the benefit of a governmental unit are not discharged in bankruptcy. (11 U.S.C. §523(a)(7)). Obviously, this will have little impact in trade debt situations. It may, however, play a role in a Chapter 11 plan where the debtor is seeking to separately classify and treat fines and penalties.

STUDENT LOANS

The Bankruptcy Code excepts from discharge student loans owed to nonprofit or governmental lenders unless paying the debt produces an undue hardship on the debtor or the debtor's dependents. (11 U.S.C. §523(a)(8)). Obviously, this exception to the discharge will have little effect on the trade creditors.

DUI LIABILITIES

In an often-amended section to the Bankruptcy Code, debts for personal injury or death arising from the operation of a motor vehicle while the debtor was intoxicated are specifically excepted. (11 U.S.C. §523(a)(9)).

PRIOR BANKRUPTCY PROCEEDINGS

Debts excepted from the discharge in a prior bankruptcy case are not discharged in subsequent bankruptcy. (11 U.S.C. §523(a)(10)). This is to prevent a debtor from using serial bankruptcies to escape liability.

FDIC CLAIMS

Certain debts to federally insured institutions are excepted from discharge under 11 U.S.C. §523(a)(11) and (12). These subsections are complex so the creditor should seek counsel.

SECURITIES FRAUD

Enacted in the wake of corporate scandals that came to light between 2001 and 2002, §523(a)(19) excepts from discharge certain debts arising from the violation of federal securities laws and those involving fraud, manipulation or other wrongful conduct in securities related transactions.

COMPLAINTS TO DETERMINE DISCHARGEABILITY/DENY DISCHARGE/DEADLINES

In order to have a debt excepted from a discharge under 11 U.S.C. §523 or to deny the discharge generally under 11 U.S.C. §727, a creditor, or the trustee, must file a timely complaint under one of those sections. This will generally require the retention of counsel.

Complaints to determine the dischargeability of a particular debt must be filed within 60 days after the first date set for the §341 meeting of creditors. The relevant dates are listed on the Notice of Commencement, the document received that advises of the bankruptcy filing. Note that a continuance of the actual meeting of creditors does not extend the deadline to file a complaint. However, this deadline applies only to §§523(a)(2) (common law fraud and false financial statements), 523(a)(4) (fraud or defalcation while acting in a fiduciary capacity, larceny or embezzlement), 523(a)(6) (willful and malicious injuries to persons or property) and 523(a)(15) (relating to divorce). The remaining sections of §523 are not subject to the 60-day time limit.

Denial of discharge under §727 must also be raised within a specific time period, but the period differs for Chapter 7 and Chapter 11. In Chapter 7 cases, the deadline is, as with §523, 60 days from the first date set for the §341 meeting of creditors. In Chapter 11, the deadline is the first date set for the hearing on confirmation of the plan.

Any of these deadlines can be extended if filing an appropriate motion with the court. The motion must be filed before the initial time period expires, however. If not timely, the motion will be denied.

When considering the filing of an 11 U.S.C. §727 complaint, the creditor must consider the impact that denial of discharge will have generally. If the creditor prevails and the court refuses to grant a discharge no claims are discharged and all creditors are free to pursue the debtor as though the bankruptcy had not been filed. While a trustee may continue to administer the estate of the debtor, and any distribution from the estate must be credited against any claim, the general denial of a discharge is of very little benefit to an individual creditor. On the other hand, if the creditor successfully files a complaint to determine dischargeability under 11 U.S.C. §523, the claim alone is excepted from the discharge under that complaint, and the creditor may be the only one with a nondischargeable claim. The creditor is, therefore, free to enter judgment against the debtor to pursue future income and assets of the debtor that other creditors will not share in.

PURSUING CLAIMS FOR FALSE FINANCIAL STATEMENTS AND FRAUD

As a trade credit manager the creditor should be familiar with the provisions of 11 U.S.C. §§523(a)(2)(A) and (a)(2)(B) relating respectively to fraudulent misconduct and the use of false financial statements. These two sections will have their primary impact in Chapter 7 cases involving individual debtors. To begin with, the creditor should note that the Bankruptcy Code places a slightly different emphasis on false financial statements than on general fraudulent misconduct. In the case of a false financial statement, the statement must be in writing. All other types of conduct fall into the fraud exception of 11 U.S.C. §523(a)(2)(A).

Fraud Other Than a False Financial Statement

Debts arising from the extension, renewal or refinancing of credit obtained through false pretenses, false representation or actual fraud are excepted from the discharge under 11 U.S.C. §523(a)(2)(A). To bring the claim within that section it must be shown that the debtor made a representation they knew at the time was false, that the debtor intended to deceive, and that the creditor had justifiably relied upon the misrepresentation with the resultant loss. The United States Supreme Court, in *Husky International Electronics Inc. v. Ritz*, recently held that Section 523(a)(2)(A)'s reference to

a debt incurred by actual fraud that gives rise to a nondischargeability claim includes various forms of fraud, including fraudulent conveyances. Generally, exceptions to discharge of this nature are construed very narrowly against creditors, and the creditor must prove the case by a preponderance of the evidence.

In the course fast-paced business world, it is often difficult to determine exactly what occurred in the sale of goods or other extensions of credit. If the creditor routinely ships to an individual or corporation, it will often be particularly difficult to prove fraud or fraudulent misrepresentation. Before pursuing a claim for fraud or false representation, the creditor should very carefully discuss the situation with an attorney.

The creditor should particularly focus on those situations where the debtor has stocked or loaded up on inventory or other goods at the creditor's expense on the eve of filing of a bankruptcy petition. Often, a debtor will load up on inventory or other goods pre-petition before filing a Chapter 7 case or to ensure that debts guaranteed by the debtor's principal are paid in full out of that inventory. This, of course, comes at the company's and its unsecured creditors' expense. It may be difficult, however, to prove the necessary elements of fraud unless there is a specific misrepresentation of ability to pay. For example, the creditor may have difficulty showing that the debtor specifically misrepresented the intention to pay. This will be particularly true if the creditor has had a course of dealing with the debtor in which the creditor routinely shipped goods on credit terms.

False Financial Statement

Under 11 U.S.C. §523(a)(2)(B), the Bankruptcy Code excepts from discharge claims arising out of the use of a materially false financial statement in writing. The financial statement may relate to the debtor or an insider of the debtor. To bring the claim within the exception of that section it must be shown that the debt arises from the use of a written financial statement, which is materially false regarding the debtor's financial condition that the debtor caused to be published with intent to deceive. Any false statements other than in a writing concerning financial condition must be brought within the previous section. The creditor's reliance on the misrepresentation must be reasonable. Again, this section is narrowly construed, and it must be proven by a preponderance of the evidence that the claim is within the very technical provisions of 11 U.S.C. §523(a)(2)(B) to prevail.

Every case is fact sensitive. Therefore, court decisions in the area are widely divergent. To begin with, a financial statement must be in writing, of course. It does not need to be a formal financial statement, and financial statements submitted to trade reporting agencies, if they contain the necessary falsity, will satisfy the initial requirement. Any financial statement submitted, however, must be substantially inaccurate and must affect the creditor's decision-making process in granting credit.

The clearest situation involves the misrepresentation of ownership of assets or the failure to list substantial noncontingent liabilities. As these omissions often change the net worth of the individual or entity, failure to disclose liabilities or improper listing of assets generally will result in the debt being excepted from discharge if the other elements are met.

The inflation of asset values, unless it can be shown that the debtor deliberately overvalued virtually worthless assets, is a more difficult situation. Generally, the courts will grant great leeway to a debtor in valuing assets for financial statement purposes. Only if the asset value is so clearly overstated that there was no reasonable basis for the debtor's valuation on the financial statement will the courts except the debt from discharge.

The other factor that causes considerable difficulty is the creditor's reliance on a false financial statement. Reliance on a false financial statement must be shown and that it influenced the decision to extend credit. Often in the hustle and bustle of trade, goods are shipped before the financial information can be received. In such situations, the courts routinely hold that the creditor did not rely on the financial statement since it had not been received when the decision to extend credit through the sale of goods was made. The reliance must also be reasonable and creditors have an obligation to investigate statements in a financial statement. This is more troublesome since, in many cases, the creditor has no way of knowing a debtor's inventory or liabilities. However, if the debtor lists assets, the creditor certainly can require some evidence of ownership.

Conversion of Collateral

Unfortunately, 11 U.S.C. §523(a)(6) has been construed to cover the conversion of collateral in business situations. "Unfortunately" since the language of the statute does not clearly apply to the sale of collateral in violation of a security agreement. This has led to widely divergent results in the courts. If in a situation where a security interest in inventory is taken and then sold to a particular debtor, and the debtor sells that inventory to third parties without accounting for the proceeds, the creditor may have a claim under 11 U.S.C. §523(a)(6).

The statute requires a showing of conversion of the collateral and a willful conversion of the proceeds. It is often difficult to prove the debtor's intent. Indeed, in most situations, the debtor uses the proceeds from the sale of inventory of goods generally in the operation of the business. Only where the debtor converts the proceeds to personal use, such as the purchase of exempt assets, have the courts generally held that the conversion was willful.

General Comment on Discharge and Dischargeability

Unless an individual debtor is a highly compensated individual, or stands to inherit substantial assets in the future, denying the debtor's discharge or excepting a claim from the operation of the discharge has little value. There is little difference between a claim that is discharged in bankruptcy and one that is uncollectible because of a debtor's lack of funds. A creditor is much better off to control its losses at the point at which the credit is granted rather than seeking to deny a discharge once bankruptcy has been filed.

TRUSTEE'S STRONG ARM AND AVOIDING POWERS

Overview and Historical Background

Bankruptcy evolved from proceedings to gather up a debtor's assets and distribute them among creditors in an equitable fashion. To further the equitable distribution, bankruptcy trustees have historically had the power to recover certain fraudulent transfers, recover preferential payments to creditors, and avoid certain improperly perfected security interests and mortgages. Collectively, these rights or powers are referred to as the trustee's *strong arm* and *avoiding* powers. From a creditor's point of view as an unsecured trade creditor, these powers are something of a two-edged sword. If a preferential payment has been recently received, the company may find itself disgorging the payment in return for the dubious right to make a claim against the bankruptcy estate generally. If, however, others have received the preferential payments, the company, as an unpaid trade creditor, may find itself in a position of receiving a dividend where otherwise nothing would have been available. The recovery of preferential and fraudulent transfers is one of the primary reasons for instituting an involuntary bankruptcy against a debtor.

Importance from an Unsecured Trade Creditor's Point of View

As a credit professional and as a potential member of an unsecured creditors' committee in Chapter 11, a creditor's concern about the trustee's powers will relate to the potential for the recovery of assets for a bankruptcy estate. As a trade creditor, it is important to make sure that any pre-petition payments received from a debtor in bankruptcy are not subject to recovery as a preference, fraudulent transfer or otherwise. As a member of the creditors' committee, on the other hand, the creditor will want to make sure that the debtor presses all possible claims for recovery, including preferences or fraudulent transfers that benefit insiders. Thus, while the creditor need not be a lawyer to understand and deal with the trustee's powers, business decisions will have to be made that require some knowledge of the law, and the creditor will have to be able to communicate with counsel, either in defending actions by the trustee or in prosecuting claims on behalf of the unsecured creditors.

As a credit professional in the nonbankruptcy context, a creditor will want to structure the company's credit terms and payments in such a fashion as to give the maximum protection from preference liability.

Basic Recovery Procedure

ADVERSARY PROCEEDINGS

Whether the action is brought by a trustee in a Chapter 7, or the debtor in possession or trustee in a Chapter 11, the procedure for recovering preferential and fraudulent transfers and setting aside improperly perfected security interests requires the filing of an adversary proceeding under Rule 7001 of the Federal Rules of Bankruptcy Procedure. The trustee may bring a single adversary proceeding to recover multiple preferential payments to a single creditor. Additionally or alternatively the trustee could object to the creditor's claim.

The adversary proceeding is usually filed in the bankruptcy court where the case is pending. Any action by a trustee to recover a money judgment against a non-insider trade creditor for recovery of less than $12,850 ($12,475 for bankruptcy cases filed before April 1, 2016), can be commenced only in the district court for the district where that trade creditor is located.

The courts are divided over whether the venue limit for small claims applies to preference claims. Some courts have ruled that the statute containing the venue limit for small claims does not apply to preference claims. Other courts have disagreed based on Congress' intent in BAPCPA to have the venue limits for small claims apply to preference claims.

The court might, upon an appropriate request, authorize the creditors' committee to pursue the action in the name of the debtor for the benefit of the bankruptcy estate. Where the debtor's schedules and statement of affairs suggest that a preference or fraudulent transfer has taken place or that the major secured creditor's security interest is subject to attack under 11 U.S.C. §544, but the debtor either refuses to or shows no sign of prosecuting the action, a creditor should discuss with committee counsel the possibility of the committee pursuing the action with court approval.

Once the adversary proceeding is filed, the trustee can obtain nationwide service of the summons and complaint pursuant to the Federal Rules of Bankruptcy Procedure. The defendant must then answer in bankruptcy court within the time specified by the bankruptcy court for an answer and, failing a timely filed answer, the court will enter a default judgment. Once an answer is filed, the adversary proceeding continues like any other lawsuit would through discovery, other pretrial activity and, if necessary, a trial. All discovery tools, such as depositions, interrogatories and requests for admission, are available in an adversary proceeding.

The United States Supreme Court has ruled that a transferee who has not filed a proof of claim is entitled to a jury trial in the preference or fraudulent transfer action. The bankruptcy court can conduct a jury trial where the parties consent. Absent that consent, any action requiring a jury trial must be transferred to the district court in the district where the bankruptcy case is pending. Generally, the demand for a jury trial is a delaying tactic. The United States District Courts are inundated with criminal work and simply do not have the time to try a preference or fraudulent transfer action in a bankruptcy case. Thus, there may be substantial delay between the filing of the action and its being brought to trial if a jury is demanded. The delays inherent in bringing the case to trial on the jury trial docket may be a major consideration in settlement negotiations.

From a tactical standpoint, there is some risk to demanding a jury trial because juries are generally ill equipped to deal with the complex legal and financial issues involved in a preference or fraudulent transfer action. If no jury trial has been demanded, the adversary proceeding will be tried in the bankruptcy court.

SETTLEMENT CONSIDERATIONS

Settlement should be considered in any preference or strong arm action. As in any litigation, the creditor should always keep an eye on the bottom line: What will the action by the debtor or the committee bring into the bankruptcy estate for distribution to unsecured creditors? Quite often, the payments are relatively small and the cost of complete litigation may outweigh the potential recovery. Unfortunately, in the bigger cases this goal occasionally disappears from sight. Remember, the cost of bringing the action, whether brought by the debtor or the creditors' committee, is paid by the bankruptcy estate. If the plan is a liquidating plan, the cost of pursuing the litigation will be paid out from the pool of money set aside for creditors.

The cost of litigation should also be a consideration on the defense side. If the creditor is defending a preference or other action to recover assets for the estate, unless there is a very clear defense, the creditor should seriously consider settlement. This is particularly true since the company may also participate in any distribution of the monies recovered, which will be diminished by litigation costs.

What follows is a discussion of the trustee's strong arm powers, the elements of a preference claim and the elements of a fraudulent transfer claim with a brief discussion of tactics from the point of view of the unsecured creditors' committee in a Chapter 11 case.

TRUSTEE'S STRONG ARM POWERS

Preliminary Comment

11 U.S.C. §544, the "strong arm clause," empowers a trustee to avoid any lien or security interest in personal property or any lien or mortgage on real estate which is not properly perfected as of the date of the filing of the bankruptcy petition. Generally, a creditor must refer to state law to understand the rights given to a trustee or a debtor in possession under 11 U.S.C. §544. For example, most state laws give priority to attaching creditors over improperly perfected security interests and incompletely conveyed real property interests. This type of priority is carried over into the Bankruptcy Code under 11 U.S.C. §544. As under state law, 11 U.S.C. §544 empowers a trustee or a Chapter 11 debtor to avoid any incomplete transfer of real estate or any improperly perfected security interest in personal property. Assume that the debtor has an inventory financing agreement with the First National Bank. The debtor also grants the bank a security interest in equipment, fixtures and accounts receivable. If First National Bank does not properly file its financing statement (UCC-1), the security interest is unperfected and is subject to attack under 11 U.S.C. §544. Similarly, if the debtor grants First National Bank a mortgage on its manufacturing site, but the mortgage incorrectly describes the real estate, even though the mortgage is recorded, the mortgage is subject to attack because of the incorrect legal description.

Section 544 grants to the trustee the rights of three different hypothetical types of creditors or purchasers. First, the trustee or the debtor in possession has the legal standing of a hypothetical judicial lien creditor who extended credit at the time of the filing of the petition, and at the same time obtained a hypothetical judicial lien on all assets of the debtor. This hypothetical judicial lien creditor status permits a trustee to attack any improperly perfected security interest in personal property or real property since, under most state laws on real estate and most versions of the UCC, a judgment lien creditor has priority over an improperly perfected secured creditor. At the same time, the trustee has the rights of any actual creditor with an allowed unsecured claim as of the date of the petition. This permits the trustee to set aside an improper bulk transfer of the debtor's property, located in states with a bulk sale statute, or a fraudulent conveyance under state law, allowing the trustee to take advantage of the longer state law statute of limitations for fraudulent conveyance actions, rather than the shorter period provided in Section 548. Finally, the trustee has the powers of a *bona fide* purchaser for value of real estate owned by the debtor as of the date of the petition. This allows the trustee to set aside any unrecorded conveyance of real estate and any improperly perfected mortgage. In most states, a judgment lien or a *bona fide* purchaser for value takes priority over any improperly recorded deed, mortgage, deed of trust or other real estate encumbrance.

Each of these hypothetical situations involves a complex relationship between federal and state law. From a general creditor's point of view, the trustee's avoiding powers under 11 U.S.C. §544 are an important device for recovering assets for the benefit of all creditors. A creditor should have sufficient understanding of the concepts to discuss them with counsel for the creditors' committee in a Chapter 11. Many times, the committee will prosecute actions to set aside certain interests if the debtor fails to do so. The avoidability of security interests is also an important consideration for negotiating a possible plan. An otherwise apparently secured creditor may be persuaded to give up value to unsecured creditors because of a potential challenge to the validity of the security interest.

Again, the creditor must generally refer to applicable state law to determine how these hypothetical standings interrelate in the bankruptcy case. The scope of this work does not contemplate a state-by-state analysis of the trustee's avoidance powers. The creditor should, however, be aware of them,

both as a potential defendant if a security interest in assets is taken and not properly perfected and as a member of an unsecured creditors' committee that may pursue avoidable transfers under the strong arm powers.

Hypothetical Judicial Lien Holder

Section 544(a)(1) of the Bankruptcy Code grants a trustee the status of a hypothetical judicial lien creditor who extended credit as of the date of the petition and simultaneously obtained a hypothetical judicial lien on the debtor's assets. In some respects the "hypothetical judicial lien holder" is as mythical as the unicorn since it would be virtually impossible to extend credit and at the same time obtain a judicial lien. The legal fiction, however, is necessary to permit a trustee or debtor in possession to set aside any security interest or mortgage for the benefit of all creditors.

Given the hypothetical status, a creditor must then refer to the applicable state law to determine whether the hypothetical judgment lien creditor has priority over consensual security interests in the debtor's assets. Most states give priority to the judicial lien holder over unperfected security interests under the UCC and unrecorded mortgages or other transfers of property.

Even with the hypothetical status granted under the Bankruptcy Code, if a judicial lien holder would not take priority over the mortgagee of real estate or the secured creditor in personal property, 11 U.S.C. §544(a)(1) does not apply. For example, under most versions of the Uniform Commercial Code, although a security interest may be enforced against the debtor even if the creditor fails to properly perfect it by the necessary filing, an unperfected security interest is subordinate to the rights of a judicial lien creditor. (*See, e.g.,* UCC §9-317(a)(2)(A).) A judicial lien holder, however, would not be able to set aside a security interest if, on the day before bankruptcy, the debtor notifies the unperfected lien holder of the pending bankruptcy and the unperfected secured creditor thereupon files the necessary financing statement. While this may fall within the purview of 11 U.S.C. §547 as a preference (*see below*), the security interest remains perfected and is not subject to avoidance under 11 U.S.C. §544(a)(1).

While it is assumed that generally a creditor will not be making secured advances to a trade customer, the creditor may wish to carefully review the documentation if, on occasion, the creditor does retain a security interest in goods sold on credit to a customer or sell goods on consignment. Finally, in the unlikely event that a creditor takes a mortgage on real estate, the creditor should have counsel review the transaction to ensure not only the proper perfection of the mortgage, but its priority with respect to other potential mortgages on the same property. In sum, a creditor should establish a legal documentation system that will ensure the proper creation and perfection of UCC security interests.

From the unsecured trade creditor's point of view, the avoidance provisions of 11 U.S.C. §544(a)(1) are of major importance. They permit a trustee or debtor in possession or the creditors' committee to recover assets for the benefit of all unsecured creditors. If the committee retains counsel, one of the first things that counsel may wish to do is review all loan documentation supporting purportedly secured claims. If the documentation indicates that the security interests are not properly perfected, the committee at least has a negotiating point with a secured creditor and may be able to avoid the interest of the creditor completely. The bottom line remains that any security interest or lien not properly perfected as of the date of the petition for relief is subject to attack under 11 U.S.C. §544(a)(1).

Unsecured Creditor Status

Pursuant to 11 U.S.C. §544(b), the trustee and the debtor in possession are given the power to avoid any transfer of assets subject to avoidance by an actual creditor with an allowable unsecured claim as of the date of the petition for relief. An actual creditor must exist, however, who could have avoided the transfer. This involves reference to applicable state law to determine the rights of actual creditors with allowed unsecured claims to set aside transfers by the debtor.

State fraudulent transfer law provides a common basis for §544(b) actions. This is of significant advantage to the bankruptcy estate because the fraudulent transfer law in the Bankruptcy Code affects only those transfers made within two years after a debtor's bankruptcy filing. State fraudulent transfer law, on the other hand, may allow the trustee to avoid transfers made during a longer reach back period.

This provision is also utilized where there has been an improper bulk transfer of the debtor's assets. This applies only to bulk transfers in states that have a bulk transfer law—Article 6 of the UCC; most states have repealed their bulk transfer statutes. For those states that retain UCC Article 6, notice and other requirements regarding such bulk sales must be satisfied. Otherwise, a creditor that extended credit before the transfer was made and had an outstanding claim at the time of the bankruptcy can unravel the bulk transfer. Because under 11 U.S.C. §544(b) the trustee is given the rights of an actual creditor, the trustee may set aside the bulk transfer. Within the reorganization setting, this avoidance power is of relatively little importance.

Bona Fide Purchaser for Value

Section 544(a)(3) of the Code is an important weapon in the hands of a trustee or creditors' committee. Congress added this provision to the Bankruptcy Code in 1978 to extend the reach of a trustee in setting aside improperly perfected transfers. Under this section, the trustee has the status of a *bona fide* purchaser for value of any property of the debtor as of the date of the petition.

Under prior case law the trustee's status as a judgment lien creditor might not permit the trustee to set aside unrecorded interests in real estate, depending upon the law in the particular state where the bankruptcy was pending. This caused inconsistent results, depending upon where the case was filed.

In most states the judgment lien holder has priority over any unrecorded deed, mortgage, deed of trust, or other encumbrance or conveyance of the property. However, some states hold that an unrecorded mortgage or deed of trust has priority over a judgment lien holder. The impact of the provision is clearest in the situation where the debtor misdescribes real estate in a conveyance which is actually recorded or where the creditor fails to record an actual conveyance, such as a mortgage or deed. In either case the trustee, as a *bona fide* purchaser for value, has priority over the interest of the holder of the inaccurate deed or the mortgagee in the unrecorded mortgage.

This section's actual effect in any given case will depend upon the type of the debtor's business. If the debtor's business has little involvement in real estate, 11 U.S.C. §544(a)(3) will be of little importance. If, on the other hand, the debtor's business involves a large number of interests in real estate, the failure to record mortgages, deeds of conveyance or other transfers of property may substantially increase the value of the bankruptcy estate. For example, in the oil and gas business it is common for a debtor, in drilling wells, to not record assignments of interests in wells until the well has been proven. When the debtor files bankruptcy before recording assignments there may be substantial recovery of assets for the general unsecured creditors.

Legal Audit

No matter what the creditor's role in a potential bankruptcy estate, if dealing with security interests and mortgages in personal and real property, the creditor should be sufficiently familiar with the law governing the creation and perfection of security interests and mortgages to perform a legal audit or review of either the company's own documentation or documentation of lending creditors in a case.

A legal audit is simply a review of all the documentation to determine whether all security interests were properly perfected and all mortgages were correct and properly recorded, paying special attention to legal descriptions of the covered real estate. If a creditor is extending credit on a secured basis, such as a purchase money security interest, the creditor should be familiar with the UCC provisions governing the steps necessary to create and perfect a purchase money security interest, including the steps necessary to prime any existing security interests in the goods the creditor sold to the debtor. The creditor would be well advised to ask counsel to periodically review the documentation and procedures to make sure they continue to conform with the UCC and other statutes.

PREFERENCES

Overview

Under common law, nothing barred a merchant from preferring one creditor over another in the payment of debts. Thus, a debtor facing the threat of insolvency would simply pay off relatives and

selected creditors, leaving nothing for the bulk of the creditors. Almost from the beginning of the bankruptcy laws in England, a trustee in bankruptcy could recover payments to unsecured creditors deemed preferential. 11 U.S.C. §547 is the Bankruptcy Code provision authorizing the trustee to recover preferential transfers.

From a creditor's point of view as an unsecured trade creditor, the preference provisions cut both ways. A creditor may receive preferential treatment and, if challenged, be required to repay those monies. In other cases, however, others have received preferential treatment and a creditor might want to encourage the trustee to recover those payments from other creditors.

Since virtually any payment on account of an antecedent debt made within 90 days of the filing of bankruptcy is at least suspect, and further, since the burden of proof is on the recipient to prove the applicability of a preference defense, a creditor should scrutinize all payments it had received from a debtor during the 90-day preference period for possible challenge.

Proving a Preference

In order to fall within the definition of a preferential transfer under 11 U.S.C. §547, a trustee must prove: (1) that a transfer of the debtor's assets was made to or for the benefit of a creditor; (2) for or on account of an antecedent debt; (3) while the debtor was insolvent; (4) within 90 days of the bankruptcy filing date or within one year if the transfer was to an insider; and (5) the effect of which is to give the creditor more than the creditor would otherwise receive in a Chapter 7 liquidation. (11 U.S.C. §547(b)). The Bankruptcy Code, for preference purposes, establishes a rebuttable presumption that the debtor is insolvent for the 90 days prior to the bankruptcy filing date. (11 U.S.C. §547(f)). The elements are described in more detail below to assist in assessing the potential for the recovery of a preference and so that a better understanding of the defenses is available.

TRANSFER OF THE DEBTOR'S PROPERTY

"Transfer" is defined broadly in 11 U.S.C. §101(54). The definition covers every mode of disposing of property whether direct or indirect, absolute or conditional, or voluntary or involuntary. Virtually any payment, gift or other transfer of assets may fall within the provisions, including any voluntary payment by the debtor of an outstanding invoice or the satisfaction of the same debt through the seizure of assets.

Remember, the transfer must be of the debtor's property. Occasionally, there is dispute as to whether the transfer is of the debtor's property. For instance, both a payment made by the debtor from the debtor's bank account and a seizure of the debtor's assets are clearly transfers of the debtor's assets. On the other hand, a debtor's principal's, or non-debtor corporate affiliate's, payment of invoices owing by a debtor is not a transfer of the debtor's assets.

PAYMENT TO OR FOR THE BENEFIT OF A CREDITOR

The transfer must be made to the creditor or somehow directly benefit the creditor. Obviously, if the debtor makes payment to the creditor, the payment falls within the scope of 11 U.S.C. §547. Less clear, however, are the situations where the debtor makes payment to an affiliate of the creditor or to a creditor of the creditor. Assume that a creditor owes a bank $15,000 and pledges accounts receivable as security. Debtor owes creditor $15,000. At the direction of the bank, the debtor pays the bank directly as the account receivable is part of its collateral. The transfer to the bank may constitute a transfer for the benefit of the creditor and, therefore, may be a recoverable preference.

In a line of cases prior to 1994, the courts held that payments to a bank might be considered preferential if the bank holds the guarantee of one of the officers or shareholders of the corporate debtor. This was referred to as the *DePrizio Doctrine*. The trustees in these cases were able to recover transfers that occurred up to one year before the bankruptcies were filed because the officers or shareholders were insiders by definition under the Bankruptcy Code. To illustrate, assume the following facts: shareholder owns 100 percent of the stock of the debtor and has guaranteed the debtor's obligations to the First National Bank. One hundred-eighty days before a filing of a bankruptcy petition, the debtor makes a substantial payment on an otherwise unsecured line of credit due to the First National

Bank. Some cases stood for the proposition that the payment may constitute a preference and that the preference period may be extended because of the relationship between the transferee, the bank, and the shareholder who is an insider with respect to the debtor.

In 1994, Congress amended the Bankruptcy Code, and it appeared that *DePrizio* had been eliminated. While BAPCPA has attempted to eliminate the risk of a *DePrizio* preference, it has also raised uncertainty about whether a non-insider creditor could still be exposed to litigation risk where claims are asserted against an insider for recovery of preferences up to a year before bankruptcy. Section 547(i) states, "If the trustee avoids under subsection (b) a transfer made between 90 days and one year before the date of the filing of the petition, by the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, such transfer shall be considered to be avoided under this section only with respect to the creditor that is an insider." This new language seems to imply that a non-insider trade creditor will become involved in a preference litigation because an insider of the debtor benefited from payment by the debtor to the non-insider. However, the language states that the transfer will not be avoided against the non-insider trade creditor. Case law will have to evolve to see how this section will actually impact the non-insider trade creditor.

Payment of Antecedent Debt

The third element of a preference claim requires that the trustee prove that the transfer was made to the creditor for or on account of an antecedent debt. Antecedent debt is not a defined term under the Bankruptcy Code. Generally, an antecedent debt was in existence prior to the alleged preferential payment. For instance, a debtor's payment of trade credit is a payment of antecedent debt. The giving of the collateral for the repayment of a loan, which was initially to be an unsecured loan, constitutes a transfer of property on account of an antecedent debt. However, payment prior to delivery of goods (cash in advance/ cash before delivery transactions) is not a preference because there is no antecedent debt being paid. A transfer to someone who is not a creditor, as a gift or otherwise, is not a payment on account of antecedent debt. (The latter, of course, would be subject to attack as a fraudulent transfer. *See below*.)

The Debtor Must Be Insolvent

The transfer must be made while the debtor was insolvent. The Bankruptcy Code relies on the balance sheet test of insolvency: the debtor's indebtedness exceeds the fair value of its non-exempt assets. The Code also creates a rebuttable presumption that the debtor is insolvent for the 90 calendar days preceding the filing of the bankruptcy. (11 U.S.C. §547(f)). The trustee is likely to rely exclusively on the presumption created by statute to prove the insolvency of the debtor.

The presumption is, however, rebuttable. If a preferential payment is received, but it can be shown by a balance sheet test that the debtor was solvent when it made the payment, the creditor will defeat the preference action. Generally, however, the presumption is all that is available since the debtor's records are often so incoherent that it is difficult to determine the debtor's financial condition immediately preceding bankruptcy. It is, therefore, very difficult, and frequently very expensive to prove the debtor's solvency at the time of the payment.

90-Day Reach Back

The transfer must be effected within 90 days of the bankruptcy filing unless the transfer is to an insider. (11 U.S.C. §101(31)). If the transferee is an insider, the reach back period is extended to one year, but the presumption of insolvency does not apply unless the transfer took place within 90 days. Therefore, the trustee has the burden of showing the insolvency of the debtor during the time from 91 days to one year prior to the bankruptcy. Note that under the Bankruptcy Code, the reach back period for a preferential transfer was shortened to 90 days from 120 days under the Bankruptcy Act of 1898.

The rules on check clearing have created some interesting case law in the preference area that was settled by the United States Supreme Court. The rule is, if a check clears within 90 days of the bankruptcy filing date, a transfer is deemed to have occurred within the 90-day period. For the purposes of §547(b) and determining when a transfer occurs, the date the check is honored is the date the transfer

occurs. Thus, if the check is tendered on the 95th day, but does not clear until the 88th day prior to the bankruptcy filing, the payment may be preferential.

Obviously, if a creditor is concerned about preferential payments the creditor may wish to take special steps to expedite payment. Putting the check through normal banking channels for payment may take several days. If the creditor can arrange to do so, the creditor may wish to have the check presented immediately at the drawee bank for payment or have the debtor pay by wire transfer or bank check. As more and more trade creditors resort to ACH payments, these issues concerning the date of clearance of payment will become less troublesome.

PREFERENTIAL EFFECT

A transfer or payment will not be preferential if it does not result in the creditor transferee getting more than the creditor would have received in a Chapter 7 liquidation. For this reason, payments of proceeds from the liquidation of collateral subject to a properly perfected security interest are generally not preferential since the creditor would receive as much in a Chapter 7 liquidation. If the security interest was improperly perfected, however, such a payment may be a preference.

Since most bankruptcy estates are no asset cases, with no money for distribution to creditors, it would seem logical that almost any payment that meets the other elements also has a preferential effect. The trustee, however, still has the burden of proving the preferential effect.

In calculating the preferential effect, the potential dividend from the bankruptcy estate as a percentage of claims is compared to a percent of the claim actually received by the transferee. Assume that the sole asset of the bankruptcy estate is a preferential transfer action against the First National Bank. There are no other assets for distribution to unsecured creditors. Thus, the dividend percentage would be zero. Even if the transfer to the bank was only five percent of its unsecured claim, the payment would be a preference since the bank had received more than what would be distributed in a Chapter 7, namely zero.

Defenses and Exceptions to the Preference Rules

OVERVIEW

The Code and the courts have created a number of exceptions to the preference rules, including exceptions for contemporaneous transfers or exchanges; ordinary course of business payments; extensions of enabling loans; subsequent advances of unsecured credit; attachments of floating liens; attachments of certain statutory liens; and small preference claims. Each of these exceptions creates a potential defense that a creditor should bear in mind in reviewing potential preference exposure. In particular, a creditor should pay attention to the contemporaneous exchange, the ordinary course of business and the subsequent advance of unsecured credit new value defenses discussed below.

CONTEMPORANEOUS EXCHANGE

A transfer to a creditor, which was intended to be contemporaneous with the extension of credit or the delivery of goods by the creditor and was a substantially contemporaneous exchange, is an exception to the preference rule. (11 U.S.C. §547(c)(1)). In its simplest form, the contemporaneous exchange exception is illustrated by a COD delivery where the debtor pays for goods delivered COD with a check tendered upon receipt of the goods. Technically, of course, the check is not paid until the check has cleared. While this situation is, in the most technical fashion, a potential preference, the provisions of the Code specifically exempt it.

Section 547(c)(1) does not require that the exchange be precisely contemporaneous with the creditor's extension of new value. The exchange only has to be substantially contemporaneous, which allows for the possibility of a short variance between the extension of credit and payment.

ORDINARY COURSE OF BUSINESS

The most frequently invoked and litigated preference defense is the ordinary course of business defense under §547(c)(2) of the Bankruptcy Code. The ordinary course of business defense is intended to protect routine payments of credit transactions from preference exposure in order to

encourage creditors to continue doing business with financially distressed debtors. It is also intended to leave normal financial relationships undisturbed since those types of transfers do not detract from the general policy of §547 to discourage unusual action by either the debtor or its creditors shortly before bankruptcy.

A trustee may not avoid a transfer based on the ordinary course of business defense to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and creditor, and was either made in the ordinary course of business or financial affairs of the debtor and the creditor (the "subjective" test) or made according to ordinary business terms (the "objective" test).

The first element of the ordinary course of business defense concerns whether the creation of the debt was within the ordinary course of business of both the debtor and creditor. In a typical extension of trade credit, this would not generally be an issue. Normally the creditor will not sell to anyone who is not in the business of buying the creditor's goods or services. Conversely, rarely would someone be purchasing from the creditor who is not in the business of dealing with the creditor's particular goods or services.

The second element of the ordinary course of business defense requires proof that the payment was made in the ordinary course of business of the debtor and creditor. The creditor must compare the alleged preference payments to the debtor's payments to the creditor prior to the 90-day preference period. A payment is in the ordinary course of business of the debtor and creditor if is consistent with their payment history; otherwise, it is not. Some courts have compared the timing of the preference payments (i.e., the number of days from invoice or due date to date of payment) to the timing of all payments by the debtor to that creditor prior to the preference period. That payment history could be anything from one year prior to the preference period, two years prior to the preference period, or longer. Where the number of days from invoice or due date to the payment date for a particular preference payment falls within the range of the earliest to latest payments characterizing the party's payment history, the payment may be in the ordinary course of business between the debtor and creditor. Other courts have compared the timing of the preference payments to a modified pre-preference period payment history between the parties that excludes payments at the outer points of the range. Other courts have compared the timing of the preference payments to the mean or average time from invoice or due date to payment date during the parties' pre-preference period payment history. Preference payments that significantly deviate from the mean or average historical payment from invoice or due date to payment may not be in the ordinary course of business of the debtor and creditor. The courts also consider, in addition to the timing of the payment, the amount, the form of tender, the circumstances of the transaction and generally the entire course of dealings between the parties.

The simple fact that a payment is late, however, does not necessarily disqualify it from being subject to the ordinary course of business defense. If the practice between the parties has been to accept late payments, many courts have held that the ordinary course of business defense could be satisfied if there is consistency with the parties' prior payment history. However, if there is no evidence that the parties have modified the original terms of payment, the courts will often find the payment is not subject to the ordinary course of business defense. Some courts have gone as far as to hold that a payment by wire transfer or cashier's check is not in the ordinary course of business where the debtor had not previously paid in that fashion.

The third element of the ordinary course of business defense requires the creditor to prove that the preference payment is consistent with the payment practices in the applicable industry. That could be the range of payment terms and practices for firms similar to the creditor. This requirement is usually satisfied as long as the payment is not idiosyncratic or unusual when compared to payments to others in the industry.

A review of the case law suggests that the ordinary course of business defense is largely based on the factual dealings between the parties. If there is a lengthy course of business stretching back over a number of years and the particular transfer which is alleged to be preferential is in compliance with those terms, the court is less likely to find it a preference and more likely to find it within the ordinary course of business exception. On the other hand, the less the particular payment looks like the

ordinary payment terms developed through practice between the parties, the more likely it is found to be a preference. All of these determinations are, to a certain extent, fact sensitive. Thus, while the parties are permitted to show prior business dealings, the creditor has the burden of showing that the transfer falls within the exception and that the exception applies.

The ordinary course of business defense is more difficult to prove than the other preference defenses. The creditor must produce witnesses and records showing its payment history with the debtor and industry practice. There has been more litigation concerning the ordinary course of business defense than any other preference defense. The courts have reached conflicting decisions that make it difficult to predict how a court will rule in a particular case. That makes litigating this defense very expensive and risky.

NEW VALUE DEFENSE

Another frequently asserted preference defense is the new value defense arising under §547(c)(4) of the Bankruptcy Code. The new value defense reduces preference exposure by the amount of new credit the creditor had extended to or for the debtor's benefit subsequent to the preference. The new value cannot be secured by an otherwise unavoidable security interest and cannot be paid by an otherwise unavoidable transfer to or for the creditor's benefit.

The new value defense, like other preference defenses, is designed to encourage creditors to continue doing business with and extending credit to a company that is in financial distress. The defense protects creditors that replenish the debtor and its bankruptcy estate by extending new credit subsequent to the preference payment. The payment leaves the debtor no worse off because the creditor had subsequently extended new credit that replenished the debtor and its bankruptcy estate.

Section 547(c)(4) does not specify how new value is to be calculated. Most courts permit creditors to offset subsequent new value against the net balance of all prior preferences. This permits preferences to be carried forward until exhausted by subsequent new value and thereby allows the new value to be applied against the immediately preceding preference and all prior preferences. This view allows for a larger deduction for new value. At least one court has limited offsettable new value to any new value granted between each preference received from the debtor. This view divides the preference period into a series of smaller periods in which new value given by the creditor is netted only against the immediately preceding preference. This has the effect of substantially reducing the amount of any new value offset.

There is also a division of authority as to whether the new value defense is available for paid for new value. One view is that in order for the §547(c)(4) new value defense to apply, the new value must remain unpaid by the debtor. These courts take the view that once the debtor pre-pays the new value, the estate is diminished and the new value defense should not be available to the creditor. An alternate view rejects any requirement that conditions the new value defense on the new value remaining unpaid. These courts rely on §547(c)(4) which states that the new value cannot be paid by an otherwise unavoidable transfer to or for the creditor's benefit. To the extent the new value is paid by an avoidable transfer (i.e., a preferential transfer not subject to the contemporaneous exchange and/or ordinary course of business defense), it should still count as new value. Again the new value defense would be substantially expanded by the applicability of paid for new value as an additional offset in reduction of the preference claim.

There is also a division of authority over whether a creditor can assert the new value defense with respect to invoices for pre-petition sales of goods or provisions of services that the debtor had paid post-petition. A debtor might pay a creditor's pre-petition claim pursuant to a critical vendor order or an order authorizing payment of the creditor's Section 503(b)(9) "20 day goods" priority claim. The U.S. Court of Appeals for the Third Circuit, in *In re Friedman's, Inc*., has held that such post-petition payments did not reduce the creditor's new value defense.

ENABLING LOAN DEFENSE

When a creditor extends credit that is secured by the asset being sold to the debtor, the security interest is referred to as a purchase money security interest and the credit extended is referred to as

an "enabling loan." The security interest may be avoidable as a preference if it was perfected after being granted and perfection occurred within the preference period.

Section 547(c)(3) of the Bankruptcy Code has a 30-day grace period within which a purchase money secured creditor must perfect its security interest in order to avoid the risk of avoidance of the security interest as a preference. This larger period of time is actually longer than the Uniform Commercial Code Article 9 period for perfection.

Small Preference Defense

Section 547(c)(9) of the Bankruptcy Code, added by BAPCPA, states that a trustee cannot recover, as preferences, transfers with an aggregate value of less than $6,425 ($6,225 for bankruptcy cases filed before April 1, 2016). This provision will make it less likely that a small preference action will be commenced. However, it has not deterred trustees from sending demand letters for payment of such small fully defensible preferences. It has also not stopped trustees from objecting to a creditor's claim on the grounds that the creditor received a preference even when based on a small preference claim. The creditor then must assert the small preference defense to oppose such objection to claim.

Preference Checklist

Unsecured trade creditors seeking to analyze and prepare their defenses to a preference claim should consider the checklist on the following pages:

1. Bankruptcy Filing.
   a. Download and save all available payment history up to two to three years before the commencement of the 90-day preference period. (An Excel spreadsheet is the preferable way to save this data.)
   b. Pull invoice copies and proofs of delivery for all items in payment history.
   c. Pull statement of account and all unpaid invoices and proofs of delivery.
   d. Pull credit file, including credit application, contract (if any), third-party credit reporting information, financial statements for the debtor, all notes in file and correspondence and preserve all emails during payment history.
2. Response to Preference Demand Letter.
   a. Do not ignore the demand.
   b. Request a list of all checks that make up the preference claim and copies of cancelled checks or proof of wire transfer with remittance instructions.
   c. Check whether all payments claimed as preferences were actually received by the creditor. A payment is made during the preference period based on check clear date. Confirm whether any of the claimed payments were bounced checks (NSF, return to maker, etc.).
   d. Statute of Limitations—Determine whether the statute of limitations has expired or will imminently expire. A complaint must be filed not greater than two years from the date of the bankruptcy filing or, if a permanent trustee is selected before the end of the two-year period, not later than the greater of two years after the bankruptcy filing or one year after such selection.
   e. If the amount of preference claim is less than $6,225 for bankruptcy cases filed before April 1, 2016, and $6,425 for bankruptcy cases filed on and after April 1, 2016, a preference lawsuit cannot be commenced.
3. Pre-Suit Discussions.
   a. Communicate defenses to trustee.
   b. Consult an attorney.
   c. Claim may not happen if close to expiration of statute of limitations.
4. Receipt of Preference Summons and Complaint.
   a. Determine answer deadline (usually 30 days from the date of the summons).

b. Try to obtain an extension of time to answer the complaint to provide an opportunity to demonstrate defenses and resolve lawsuit.
c. Immediately refer to counsel if the creditor is unable to obtain an extension of time to answer the complaint or a default has been entered.
d. A corporation is not permitted to answer a complaint by itself. A corporation must be represented by counsel.
e. To the extent not previously done, obtain information regarding the alleged preferences, (i.e., list of preference payments and copies of cancelled checks, wire information, payment advices, etc.).

5. Rebuttal of Elements of Preference Claim.
   a. Cash in Advance—Determine whether the payments were cash in advance payments (i.e., paid in advance of shipment of goods or provision of services). Cash in advance payments are not preferences because they did not pay antecedent debt and, therefore, do not satisfy one of the requirements of a preference claim.
   b. Creditor paid out of trust funds (PACA, builders trust fund), which is not property of debtor and is not subject to preference risk.
   c. Solvency—Check bankruptcy schedules and financial statements covering the preference period or shortly before the preference period to rebut the presumption of insolvency (liabilities exceed assets).
   d. Creditor fully secured by debtor's assets or paid from collateral proceeds is not subject to preference exposure.
6. Preference Defenses.
   a. Contemporaneous Exchange for New Value Defense.
      i. For COD transactions or payments in exchange for waiver or release of lien rights against the debtor's property.
      ii. Although there are no bright line rules as to what constitutes a substantially contemporaneous transfer, a payment made within 10 days of provision of goods or services or waiver of lien should satisfy this defense. The further outside the 10-day period, the less likely this defense applies.
      iii. The defense is lost if the check bounces and is subsequently replaced, unless in the case of a bounced check in exchange for a lien waiver/release, the waiver/release is conditioned on receipt of good funds.
   b. New Value Defense.
      i. Prepare new value analysis and determine the net preference exposure after deducting new value.
      ii. New value is the value of goods or services provided during the 90-day preference period after receipt of the alleged preference payments. New value cannot be applied toward a check that was received after provision of goods or services.
      iii. New value should be counted as of the date it was provided—goods shipped, services provided, which might be (but is not necessarily) the invoice date.
      iv. Most courts calculate new value after delivery of the payment, rather than using the clear date of the payment. Delivery is usually receipt of the preference, though some courts do the calculation from date of mailing of the payment.
      v. New value should include paid and unpaid new value as of the bankruptcy filing date. *CAVEAT*: A trustee in a jurisdiction that rejects paid new value might reject deduction of paid for new value, but its applicability as a defense might still be negotiable.
   c. Ordinary Course of Business Defense.
      i. To prove the payments were ordinary between the debtor and creditor, the creditor should prepare a payment history (one year/one-and-a-half years/two years/three years

before the preference period) that compares the days outstanding prior to the preference period to the days outstanding during the preference period and shows that the average days to payment prior to the preference period was consistent with the days to payment during the preference period. Run different scenarios (different payment history durations) until the desired outcome is reached. Reduced terms during the preference period, change in mode of payment (regular check to wire), change in mode of delivery of payment (regular mail to overnight courier), collection action (threats to cut off shipments, decision to enforce credit limit), and an increased number of invoices paid during or shortly before the commencement of the preference period might result in inability to prove the payment was ordinary between the parties.

ii. The creditor can prove ordinary business terms by using industry data, such as from the Credit Research Foundation, industry credit group, third-party credit reporting agency or comparable data for the creditor's and debtor's industries and showing the preference payment terms were consistent with the range of terms in the industry.

d. Administrative Claims—Most courts do not consider, as new value, administrative priority claims on account of open invoices for goods and services provided after the bankruptcy filing date. Nonetheless, administrative claims should be asserted as a set-off to the preference and counterclaim and might reduce preference exposure, unless they are time-barred as having not been asserted prior to an administrative claims bar date.

7. Settlement.
   a. Have counsel review the settlement agreement.
   b. Make sure the settlement agreement provides for a general release in favor of the creditor or, at least, waives all preference claims.
   c. Do not ignore the value of the creditor's right under Bankruptcy Code Section 502(h) to file an unsecured claim for the settlement amount. That claim could reduce the amount of any settlement payment or provide a later recovery that effectively reduces the settlement amount. Watch this one very carefully. Most trustees will try to have the creditor waive its right to file a Section 502(h) claim in addition to paying money back.

FRAUDULENT TRANSFERS

Elements

The Bankruptcy Code currently permits a trustee to avoid two different types of fraudulent transfers made within two years of the filing of bankruptcy. Under 11 U.S.C. §548(a), transfers of a debtor's property made with the *actual* intent to hinder, delay or defraud creditors and transfers of property for less than reasonably equivalent value at a time when the debtor was insolvent or inadequately capitalized may be set aside.

To prevail in the first instance, a trustee must show that the debtor transferred property with the actual intent to defraud its creditors. The debtor's intent will generally be inferred from the circumstances surrounding the transfer since the debtor rarely confesses to the necessary intent. Bankruptcy courts consider the following factors: (1) whether the debtor received fair value for the property actually transferred; (2) whether the debtor became insolvent or was insolvent at the time of the transfer; (3) the amount of the property transferred; (4) the length of time that elapsed between the transfer and the filing of the bankruptcy; (5) the remaining assets available to the debtor after making the transfer; (6) the debtor's records of other transactions before filing bankruptcy; and (7) the existence of a relationship between the debtor and the transferee. A court will generally set aside a transfer if it concludes that the debtor had the necessary fraudulent intent unless the debtor clearly received an equivalent value in money or money's worth in return for the transfer of the asset.

As a practical matter, this type of fraudulent transfer action will rarely be brought by a debtor in possession since it would require it to admit fraudulent intent, something that is unlikely to engender a great deal of faith in its ability to carry on in business. If, however, as a member of the creditors' committee, a creditor becomes aware of facts that suggest that a transfer was made fraudulently, the

committee may, with permission from the court, bring the fraudulent transfer action and recover the assets for the estate.

The second type of fraudulent transfer requires no evidence of a fraudulent intent. A trustee may set aside transfers that the Code deems constructively fraudulent where the debtor received less than reasonably equivalent value for the property transferred even if the debtor received legal consideration.

If the court concludes that the debtor received reasonably equivalent value for the transfer, then that is the end of the matter. If, however, the debtor received less than reasonably equivalent value, a trustee must additionally show one of the following: (1) that the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer; (2) that the debtor was in business and an unreasonably small amount of capital remained after the transfer was completed; or (3) that the debtor intended to incur debts beyond the debtor's ability to pay in the future.

The simplest example of a fraudulent transfer of this type is where a debtor transfers an asset to a relative or friend with the understanding that the asset will be retransferred after the bankruptcy case is closed. More complex are the situations where the debtor creates a sham debt and grants a lien on the property to secure the debt.

Section 548 of the Bankruptcy Code also enables a trustee to recover avoidable transfers and excessive pre-petition compensation, such as bonuses, paid to insiders of a debtor. A trustee could recover any transfer or avoid any obligation incurred for the benefit of an insider under an employment contract, and not in the ordinary course of business, if the debtor did not receive reasonably equivalent value. Section 548(e) was also added to protect against self-settled trusts by allowing a trustee to avoid any transfer of an interest of the debtor in property that was made within 10 years of the date of commencement of the bankruptcy case if the: (1) transfer was made to a self-settled trust or similar device; (2) transfer was made by the debtor; (3) the debtor was a beneficiary of the trust; and (4) the debtor made the transfer with actual intent to hinder, delay or defraud a present or future creditor. Transfers avoidable by this new subsection include transfers in anticipation of a money judgment, settlement, civil penalty or fine for violation of securities laws and regulations arising out of fraud, deceit and manipulation in a fiduciary capacity or in connection with the purchase or sale of any regulated security.

Defenses

Under the Bankruptcy Code, a transferee that takes for value and in good faith is entitled to a lien on the property transferred or may retain any interest transferred to the extent that such transferee gave value. (11 U.S.C. §548(c)). To fall within this savings provision, the transferee must show that it gave value for the transfer and that the transfer was made in good faith.

Tactics

If a customer the creditor suspects is contemplating bankruptcy offers a payment on an unsecured claim, the creditor should generally accept the payment. Although the payment may later be deemed a preference, there is always the possibility that the debtor will not file bankruptcy at all or, if it does file, it will file more than 90 days after the payment is received. In either event, the payment will not be recoverable as a preference. Even if the bankruptcy is filed, the trustee may determine the cost of litigation outweighs any potential recovery or, if the preference action is filed, the payment may fit within one of the statutory exceptions. In other words, the worst that can happen is that the creditor will have to pay the money back. Thus, when offered payment by a debtor in financial difficulties, *accept the payment*.

As a member of the creditors' committee, a creditor will want to carefully review the debtor's security agreements for possible preference and other avoidance claims and scrutinize all transfers made within two years preceding the bankruptcy filing for potential fraudulent transfer claims. If a debtor is unable or unwilling to take action against some of its creditors, the creditors' committee may wish to intervene.

Like any lawsuit, it is important to evaluate the case at the outset. Far too often, creditors force the debtor or trustee to litigate actions that have little potential benefit, but involve tremendous expense

to the bankruptcy estate. As the debtor's and the committee's legal fees are paid out of the monies available for distribution to the unsecured creditors, pursuit of costly litigation may result in the creditor fighting itself with its own money. Creditors should give counsel instructions on time and expense limits in pursuing recovery of transfers.

Involuntary Bankruptcy

The filing of an involuntary bankruptcy is used by creditors to force recovery of fraudulent and preferential transfers. (*See above*.) Since the common law does not prevent a debtor from preferring one creditor over others and gives creditors only a limited ability to recover fraudulent transfers, the filing of an involuntary bankruptcy may be the only way of stopping and recovering these types of transfers.

A creditor will want to monitor the debtor. If the creditor becomes aware of activities that suggest the debtor is rapidly depleting its assets or if the debtor is preferring creditors through the payment of some unsecured claims over others, including the creditor's, the creditor may wish to consider the filing of an involuntary bankruptcy petition against the debtor. As a general rule, if a debtor has 12 or more creditors, the creditor needs at least two other creditors for a total of three creditors, with unsecured claims, not contingent as to liability or subject to *bona fide* dispute as to liability or amount, totaling at least $15,775, to be petitioning creditors. Where the debtor has fewer than 12 otherwise eligible unsecured creditors, excluding any employee or insider and any recipient of a voidable transfer, such as a preference or fraudulent conveyance, then one such unsecured creditor, with a claim of at least $15,775, that is not subject to *bona fide* dispute as to liability or amount, can file an involuntary bankruptcy petition.

Each petitioning creditor must hold a claim that is not contingent as to liability and not the subject of a *bona fide* dispute "as to liability or amount." The petitioning creditors' non-contingent, undisputed claims must total at least $15,725 more than any liens securing such claims.

The Official Forms for involuntary bankruptcy petitions are Form 105 for involuntary petitions against individuals and Form 205 for involuntary petitions against non-individuals. These forms are included at the end of this chapter.

To be successful on an involuntary bankruptcy petition, the petitioning creditor also must prove that the debtor is generally not paying its undisputed debts as they mature. Remember, however, that if the court fails to order relief, the creditor may be held liable for any loss by or damage to the debtor by the filing of the involuntary bankruptcy petition, including the debtor's professional fees incurred in defending the petition and actual and possibly punitive damages for a bad faith filing. These damage claims could be very large. Successful petitioning creditors would be entitled to an administrative priority claim for their fees in prosecuting the petition.

MASTER CHECKLIST

Caveat

This checklist is primarily aimed at assisting nonlawyers in making an initial evaluation of a bankruptcy case. It is not intended as a substitute for counsel. In many of the cases, the checklist will help in determining whether to refer the case to counsel or close the case entirely.

Routing System

At the outset it is imperative that the creditor set up an appropriate routing system for *all* bankruptcy notices. The creditor could prescribe the address to which notices are sent by sending at least two letters to the debtor prior to the bankruptcy with the debtor's account number and the creditor's address where notices must be sent. Particularly if the accounts receivable are paid through a lockbox or other direct deposit system, bankruptcy notices need to be rerouted *directly* to whomever is responsible for making decisions and taking action in bankruptcy cases. This may involve filing a change of address with the bankruptcy court at the very beginning of the case to reroute the bankruptcy notices from the lockbox to the responsible party.

Internally, the bankruptcy system should route copies of notices to all individuals who make decisions concerning customers. The sales department, as well as the credit department, may need to know of the bankruptcy filing and should receive copies of any notices. The routing system should establish a single file for all notices. The file should also contain other credit information concerning the debtor and copies of any credit memos or other documentation relating to sales of goods or services to the debtor.

Finally, the file should contain sufficient information for the creditor to determine the amount of its pre-petition claim and any post-petition credit extended to a debtor in possession in a Chapter 11. Separate documentation as to post-petition credit is very important, as unpaid post-petition credit will be treated differently (more favorably) from pre-petition claims. (*See above.*)

BANKRUPTCY CHECKLIST

Response to Initial Bankruptcy Notice

1. Stop any collection activity.
2. Review the initial bankruptcy notice and determine the size of any claim the creditor's company holds against the debtor.
3. If the claim is small and does not justify the assistance of counsel in the reorganization process, file a claim and close the file.
4. Gather all documentation relating to the claim for possible transmittal to counsel with instructions for action in the case.
5. Notify the sales department of any restrictions on post-petition credit sales to the debtor in possession.

Reclamation/Goods in Transit/New Administrative Claim

1. Determine whether any goods are in transit or have been delivered immediately prior to the petition which may be subject to reclamation under Section 546(c) of the Bankruptcy Code.
2. Stop all goods in transit through notice to the common carrier delivering the goods.
3. Serve a written reclamation demand upon the debtor for goods received by the debtor within 45 days prior to bankruptcy.
4. Reclamation or stoppage of goods in transit will probably require reference to counsel for further action. (*See also* Chapter 1, which discusses reclamation and related remedies in *Volume IV*.)
5. There is also an administrative priority claim in favor of goods suppliers for the goods received by the debtor within 20 days prior to the bankruptcy filing. This claim is granted administrative priority status under Section 503(b)(9) of the Bankruptcy Code. For goods sold to a debtor in the ordinary course of business, and delivered within 20 days prior to the bankruptcy filing, that creditor is granted new protection, separate and apart from its reclamation rights. A creditor can assert an administrative expense claim for the value of the goods. The creditor is not required to send written notice, or prove that the goods are still in the debtor's possession, or satisfy any of the other requirements mandated for a successful reclamation claim. The creditor must, however, prove that the goods were received by the debtor within 20 days before the onset of the case. The claim is not automatic and will be granted only upon notice and a hearing. The creditor will have to make an application in the bankruptcy court for allowance and payment of an administrative expense claim for the value of the goods. The creditor should check the local bankruptcy rules where the case is pending to confirm whether there is a deadline for asserting this claim. Administrative expenses are paid before most of the other creditors' claims and are frequently, but not always, paid in full.

   Alternatively, a debtor may request court approval of procedures for handling reclamation and Section 503(b)(9) administrative claims. This may include filing a proof of claim to assert a Section 503(b)(9) claim. If a court order is entered providing such procedures, it is

the creditor's responsibility to follow the procedures to obtain more favorable treatment of its claim, including timely filing the requisite proof of claim. (*See also* Chapter 1, which discusses reclamation and related remedies in *Volume IV*.)

Participation on the Chapter 11 Creditors' Committee

If a Chapter 11 case is filed, the creditor should review the file and the prospects for reorganization to determine whether appointment to the creditors' committee would assist in the reorganization process. If the creditor wishes to participate in the reorganization as a member of the creditors' committee, the creditor should contact the United States Trustee for the district in which the case is pending and volunteer for membership on the committee. Also, the creditor should fill out and return the solicitation form sent by the United States Trustee to the debtor's larger creditors inquiring about their serving on the committee.

Deadline for Filing Claims

CHAPTER 7

It is not likely that the initial notice of the bankruptcy will indicate a deadline for filing a proof of claim. If the trustee discovers assets available for distribution, the creditor will receive a separate notice advising that the proof of claim needs to be filed and the deadline by which the creditor must comply.

NOTE that the filing of a claim might submit the creditor to the jurisdiction of the bankruptcy court and might constitute the waiver of a right to a jury trial in certain preference and fraudulent transfer actions.

CHAPTER 11

1. Determine the deadline for the filing of claims from the initial notice. If no deadline is established in the initial notice, the creditor should review the file periodically for deadlines subsequently established by the court.
2. If the court has established a deadline for the filing of claims in the initial notice, the creditor should review the file and determine whether the company intends to file a claim. If so, the creditor should file the claim within the deadline established.
3. Even if the court does not establish a deadline in the initial notice, the creditor may wish to file a claim immediately.

NOTE that under 11 U.S.C. §1111(a), a claim is deemed filed in Chapter 11 and under §925, a claim is deemed filed in a Chapter 9 case (but not in Chapters 7, 12 or 13) unless the debtor has listed the creditor's claim as disputed, contingent or unliquidated in the schedules. Since the creditor may not be able to review the court file and determine how the company is listed, the creditor may have to file a claim.

NOTE that the filing of a claim might submit the creditor to the jurisdiction of the bankruptcy court and might constitute the waiver of a right to a jury trial in certain preference and fraudulent transfer actions.

CHAPTER 12

The deadline is 90 days from the date first set for the §341 meeting. Generally, the notice sent by the bankruptcy court will establish the deadline.

NOTE that the filing of a claim might submit the creditor to the jurisdiction of the bankruptcy court and might constitute the waiver of a right to a jury trial in certain preference and fraudulent transfer actions.

CHAPTER 13

The deadline is 90 days from the date first set for the §341 meeting. Generally, the notice sent by the bankruptcy court will establish the deadline.

NOTE that the filing of a claim might submit the creditor to the jurisdiction of the bankruptcy court and might constitute the waiver of a right to a jury trial in certain preference and fraudulent transfer actions.

Deadlines for Objections to Discharge and Complaints to Determine Dischargeability

A creditor should review the initial notice for the deadlines established for any objections to discharge and complaints to determine dischargeability. If the deadlines are established, the creditor should consult counsel about any complaints to determine dischargeability or objections to discharge well prior to the deadline so counsel can timely file the necessary complaint.

Motions for Trustee or Examiner in Chapter 11

If a creditor intends to participate actively in the case, the creditor may want to review the facts to determine whether the appointment of a trustee or an examiner is warranted. Generally, it will be necessary to consult counsel to file a motion.

Subsequent Notices

Review all other notices received from the court to determine whether action is required.

NOTICE OF HEARING ON AN APPLICATION FOR USE OF CASH COLLATERAL

Generally, the debtor in Chapter 11 will propose to use cash collateral in the continued operation of the business immediately after the filing of the petition. Failure to object to the use of cash collateral may waive the right to object.

MOTION FOR RELIEF FROM STAY

Generally, secured creditors will seek relief from the automatic stay to foreclose their security interest in property of the estate shortly after the petition is filed. The creditor may need to consult with counsel to determine how the relief from stay might affect the creditor's rights as a secured creditor or consignor in any property of the bankruptcy estate.

NOTICE OF INTENDED SALE OF ESTATE ASSETS

If a security interest or other right to property in the possession of the debtor is claimed, the creditor's rights may be affected and even eliminated through the sale of the property by the debtor. Generally, any sale other than in the ordinary course of business will have to be noticed to all creditors. If the creditor fails to object to the intended sale, the creditor's rights with respect to property in the hands of the estate may be waived.

NOTICE OF HEARING ON DISCLOSURE STATEMENT

The court will generally require the debtor in Chapter 11 to give notice of the filing of the disclosure statement and plan. A creditor may not actually receive a copy of the disclosure statement and plan at the preliminary stages of the case; rather, the court will direct that notice be given. If a copy of the disclosure statement and plan is needed, the creditor should request them from the debtor.

Once the disclosure statement and plan is received, an objection to the adequacy of the information furnished may be made, although this will require the assistance of counsel.

Notice of Confirmation Hearing: Chapter 11, 12 or 13

Once a plan has been filed (and a disclosure statement approved in Chapter 11), the court will require the debtor or other proponent of the plan to give notice of the confirmation of the plan. Attached to the notice will be the plan and disclosure statement previously approved by the court. The creditor will also receive a ballot for voting on the plan in Chapter 11. No ballot will be sent in Chapter 12 or 13, as creditors do not vote on plans in those cases.

The creditor should immediately review the notice to confirm any deadlines for objections to the plan and the date for the confirmation hearing. The creditor should also review the deadline for the filing of the ballot in connection with the plan in Chapter 11.

The creditor should thereafter review the plan provisions with counsel to determine whether there are any objections to confirmation or, in Chapter 11, how the creditor should vote. Generally, the creditor should review the proposed distribution to the claim in making a decision on voting on the plan.

Thereafter, in Chapter 11, the creditor will want to file the ballot in time for the court or proponent to receive it well before the confirmation hearing. The creditor may accept or reject the plan and, if more than one plan is before the creditors, the creditor may accept or reject any of them and indicate a preference for one plan over all others. While the filing of the ballot will not require the assistance of counsel, counsel will be necessary to file objections to confirmation. If the creditor elects to object to confirmation of the proposed plan, the creditor should consult counsel.

Fee Applications

The court must approve all applications for fees and expenses presented by professionals employed by the debtor, the creditors' committee and the trustee, and fee applications from the trustee or examiner, if one is appointed, after notice to creditors. Generally, professionals will be paid on an hourly basis. Hourly rates vary widely from one part of the country to another. As national law firms and accounting firms become more and more common, the bankruptcy courts have become more experienced in awarding fees based on specific criteria set forth by the Office of the United States Trustee. These criteria include the complexity of the case being handled, the experience level of the professional, and the uniqueness or routine of a particular matter. A provision added by BAPCPA is with respect to a professional person, whether the person is board certified or otherwise has demonstrated skill and experience in the bankruptcy field.

As an unsecured creditor, the creditor will be concerned that the fees not be excessive and that they be reasonably related to the results in the case. There will be an opportunity to object to the award of the fees. The objection will have to be in writing and filed with the bankruptcy court prior to any deadline established in the notice of the fee application. If the creditor is objecting to the hourly rates, the time spent or the results achieved, the creditor will have to demonstrate that the fee request is unreasonable in light of the size of the case, normal hourly rates in the area where the case is pending or the results achieved. This may require the employment of an expert witness to testify on any of those issues.

Postconfirmation Motions

A debtor or other proponent of a plan may propose modifications of the plan up until the time the plan is substantially consummated. Substantial consummation is discussed above and generally involves the transfer of any assets involved in the case and the commencement of payments to creditors pursuant to a confirmed plan. The creditor will be given an opportunity to object to any postconfirmation modification of the plan. Quite often, postconfirmation modifications will be an attempt to delay payments because the operating results have not been as projected.

APPLICABLE FORMS

OFFICIAL FORM 410
PROOF OF CLAIM

Fill in this information to identify the case:

Debtor 1 _____

Debtor 2 (Spouse, if filing) _____

United States Bankruptcy Court for the: _____ District of _____

Case number _____

Official Form 410

Proof of Claim

04/16

Read the instructions before filling out this form. This form is for making a claim for payment in a bankruptcy case. Do not use this form to make a request for payment of an administrative expense. Make such a request according to 11 U.S.C. § 503.

Filers must leave out or redact information that is entitled to privacy on this form or on any attached documents. Attach redacted copies of any documents that support the claim, such as promissory notes, purchase orders, invoices, itemized statements of running accounts, contracts, judgments, mortgages, and security agreements. **Do not send original documents;** they may be destroyed after scanning. If the documents are not available, explain in an attachment.

A person who files a fraudulent claim could be fined up to $500,000, imprisoned for up to 5 years, or both. 18 U.S.C. §§ 152, 157, and 3571.

Fill in all the information about the claim as of the date the case was filed. That date is on the notice of bankruptcy (Form 309) **that you received.**

Part 1: Identify the Claim

1. **Who is the current creditor?**

_____
Name of the current creditor (the person or entity to be paid for this claim)

Other names the creditor used with the debtor _____

2. **Has this claim been acquired from someone else?**

❑ No
❑ Yes. From whom? _____

3. **Where should notices and payments to the creditor be sent?**

Federal Rule of Bankruptcy Procedure (FRBP) 2002(g)

Where should notices to the creditor be sent?	**Where should payments to the creditor be sent?** (if different)
_____ Name	_____ Name
_____ Number Street	_____ Number Street
_____ City State ZIP Code	_____ City State ZIP Code
Contact phone _____	Contact phone _____
Contact email _____	Contact email _____

Uniform claim identifier for electronic payments in chapter 13 (if you use one):

— —

4. **Does this claim amend one already filed?**

❑ No
❑ Yes. Claim number on court claims registry (if known) _____ Filed on _____ MM / DD / YYYY

5. **Do you know if anyone else has filed a proof of claim for this claim?**

❑ No
❑ Yes. Who made the earlier filing? _____

Part 2: Give Information About the Claim as of the Date the Case Was Filed

6. **Do you have any number you use to identify the debtor?**
   - ❑ No
   - ❑ Yes. Last 4 digits of the debtor's account or any number you use to identify the debtor: ____ ____ ____ ____

7. **How much is the claim?** $_____. **Does this amount include interest or other charges?**
   - ❑ No
   - ❑ Yes. Attach statement itemizing interest, fees, expenses, or other charges required by Bankruptcy Rule 3001(c)(2)(A).

8. **What is the basis of the claim?**
   Examples: Goods sold, money loaned, lease, services performed, personal injury or wrongful death, or credit card.
   Attach redacted copies of any documents supporting the claim required by Bankruptcy Rule 3001(c).
   Limit disclosing information that is entitled to privacy, such as health care information.
   _____

9. **Is all or part of the claim secured?**
   - ❑ No
   - ❑ Yes. The claim is secured by a lien on property.

   Nature of property:
   - ❑ Real estate. If the claim is secured by the debtor's principal residence, file a *Mortgage Proof of Claim Attachment* (Official Form 410-A) with this *Proof of Claim.*
   - ❑ Motor vehicle
   - ❑ Other. Describe: _____

   Basis for perfection: _____
   Attach redacted copies of documents, if any, that show evidence of perfection of a security interest (for example, a mortgage, lien, certificate of title, financing statement, or other document that shows the lien has been filed or recorded.)

   Value of property: $_____
   Amount of the claim that is secured: $_____
   Amount of the claim that is unsecured: $_____ (The sum of the secured and unsecured amounts should match the amount in line 7.)

   Amount necessary to cure any default as of the date of the petition: $_____

   Annual Interest Rate (when case was filed)_____%
   - ❑ Fixed
   - ❑ Variable

10. **Is this claim based on a lease?**
    - ❑ No
    - ❑ Yes. **Amount necessary to cure any default as of the date of the petition.** $_____

11. **Is this claim subject to a right of setoff?**
    - ❑ No
    - ❑ Yes. Identify the property: _____

12. **Is all or part of the claim entitled to priority under 11 U.S.C. § 507(a)?**

A claim may be partly priority and partly nonpriority. For example, in some categories, the law limits the amount entitled to priority.

❑ No

❑ Yes. *Check one:*

	Amount entitled to priority
❑ Domestic support obligations (including alimony and child support) under 11 U.S.C. § 507(a)(1)(A) or (a)(1)(B).	$_____
❑ Up to $2,850* of deposits toward purchase, lease, or rental of property or services for personal, family, or household use. 11 U.S.C. § 507(a)(7).	$_____
❑ Wages, salaries, or commissions (up to $12,850*) earned within 180 days before the bankruptcy petition is filed or the debtor's business ends, whichever is earlier. 11 U.S.C. § 507(a)(4).	$_____
❑ Taxes or penalties owed to governmental units. 11 U.S.C. § 507(a)(8).	$_____
❑ Contributions to an employee benefit plan. 11 U.S.C. § 507(a)(5).	$_____
❑ Other. Specify subsection of 11 U.S.C. § 507(a)(__) that applies.	$_____

* Amounts are subject to adjustment on 4/01/19 and every 3 years after that for cases begun on or after the date of adjustment.

Part 3: Sign Below

The person completing this proof of claim must sign and date it. FRBP 9011(b).

If you file this claim electronically, FRBP 5005(a)(2) authorizes courts to establish local rules specifying what a signature is.

A person who files a fraudulent claim could be fined up to $500,000, imprisoned for up to 5 years, or both. 18 U.S.C. §§ 152, 157, and 3571.

Check the appropriate box:

❑ I am the creditor.

❑ I am the creditor's attorney or authorized agent.

❑ I am the trustee, or the debtor, or their authorized agent. Bankruptcy Rule 3004.

❑ I am a guarantor, surety, endorser, or other codebtor. Bankruptcy Rule 3005.

I understand that an authorized signature on this *Proof of Claim* serves as an acknowledgment that when calculating the amount of the claim, the creditor gave the debtor credit for any payments received toward the debt.

I have examined the information in this *Proof of Claim* and have a reasonable belief that the information is true and correct.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on date _____
MM / DD / YYYY

_____
Signature

Print the name of the person who is completing and signing this claim:

Name _____
First name Middle name Last name

Title _____

Company _____
Identify the corporate servicer as the company if the authorized agent is a servicer.

Address _____
Number Street

_____
City State ZIP Code

Contact phone _____ Email _____

OFFICIAL FORM 105
INVOLUNTARY PETITION AGAINST AN INDIVIDUAL

Fill in this information to identify the case:

United States Bankruptcy Court for the:

_____ District of _____

Case number (*If known*): _____ Chapter _____

❑ Check if this is an amended filing

Official Form 105

Involuntary Petition Against an Individual 12/15

Use this form to begin a bankruptcy case against an individual you allege to be a debtor subject to an involuntary case. If you want to begin a case against a non-individual, use the *Involuntary Petition Against a Non-individual* (Official Form 205). Be as complete and accurate as possible. If more space is needed, attach a separate sheet to this form. On the top of any additional pages, write name and case number (if known).

Part 1: Identify the Chapter of the Bankruptcy Code Under Which Petition Is Filed

1. **Chapter of the Bankruptcy Code**

Check one:

❑ Chapter 7
❑ Chapter 11

Part 2: Identify the Debtor

2. **Debtor's full name**

_____
First name

_____
Middle name

_____
Last name

_____
Suffix (Sr., Jr., II, III)

3. **Other names you know the debtor has used in the last 8 years**

Include any assumed, married, maiden, or trade names, or *doing business as* names.

_____
_____
_____

4. **Only the last 4 digits of debtor's Social Security Number or federal Individual Taxpayer Identification Number** (ITIN)

❑ Unknown

xxx – xx – ____ ____ ____ ____ OR 9xx – xx – ____ ____ ____ ____

5. **Any Employer Identification Numbers (EINs) used in the last 8 years**

❑ Unknown

__ __ – __ __ __ __ __ __ __
EIN

__ __ – __ __ __ __ __ __ __
EIN

Debtor _____ Case number *(if known)*_____

6. Debtor's address

Principal residence

_____
Number Street

_____

_____
City State ZIP Code

_____
County

Mailing address, if different from residence

_____
Number Street

_____

_____
City State ZIP Code

Principal place of business

_____
Number Street

_____

_____
City State ZIP Code

_____
County

7. Type of business

❑ Debtor does not operate a business

Check one if the debtor operates a business:

❑ Health Care Business (as defined in 11 U.S.C. § 101(27A))
❑ Single Asset Real Estate (as defined in 11 U.S.C. § 101(51B))
❑ Stockbroker (as defined in 11 U.S.C. § 101(53A))
❑ Commodity Broker (as defined in 11 U.S.C. § 101(6))
❑ None of the above

8. Type of debt

Each petitioner believes:

❑ **Debts are primarily consumer debts.** *Consumer debts* are defined in 11 U.S.C. § 101(8) as "incurred by an individual primarily for a personal, family, or household purpose."

❑ **Debts are primarily business debts.** *Business debts* are debts that were incurred to obtain money for a business or investment or through the operation of the business or investment.

9. Do you know of any bankruptcy cases pending by or against any partner, spouse, or affiliate of this debtor?

❑ No

❑ Yes. Debtor _____ Relationship _____

District _____ Date filed _____ Case number, if known_____
MM / DD / YYYY

Debtor _____ Relationship _____

District _____ Date filed _____ Case number, if known_____
MM / DD / YYYY

Debtor _____ Case number (*if known*)_____

Part 3: Report About the Case

10. Venue

Reason for filing in this court.

Check one:

- ❑ Over the last 180 days before the filing of this bankruptcy, the debtor has resided, had the principal place of business, or had principal assets in this district longer than in any other district.
- ❑ A bankruptcy case concerning debtor's affiliates, general partner, or partnership is pending in this district.
- ❑ Other reason. Explain. (See 28 U.S.C. § 1408.) _____

11. Allegations

Each petitioner is eligible to file this petition under 11 U.S.C. § 303(b).

The debtor may be the subject of an involuntary case under 11 U.S.C. § 303(a).

At least one box must be checked:

- ❑ The debtor is generally not paying such debtor's debts as they become due, unless they are the subject of a bona fide dispute as to liability or amount.
- ❑ Within 120 days before the filing of this petition, a custodian, other than a trustee, receiver, or agent appointed or authorized to take charge of less than substantially all of the property of the debtor for the purpose of enforcing a lien against such property, was appointed or took possession.

12. Has there been a transfer of any claim against the debtor by or to any petitioner?

- ❑ No
- ❑ Yes. Attach all documents that evidence the transfer and any statements required under Bankruptcy Rule 1003(a).

13. Each petitioner's claim

Name of petitioner	Nature of petitioner's claim	Amount of the claim above the value of any lien
		$ _____
		$ _____
		$ _____
	Total	$ _____

If more than 3 petitioners, attach additional sheets with the statement under penalty of perjury, each petitioner's (or representative's) signature under the statement, along with the signature of the petitioner's attorney, and the information on the petitioning creditor, the petitioner's claim, the petitioner's representative, and the attorney following the format on this form.

Debtor _____ Case number (*if known*)___

Part 4: Request for Relief

Petitioners request that an order for relief be entered against the debtor under the chapter specified in Part 1 of creditor is a corporation, attach the corporate ownership statement required by Bankruptcy Rule 1010(b). If any representative appointed in a foreign proceeding, a certified copy of the order of the court granting recognition i

Petitioners declare under penalty of perjury that the information provided in this petition is true and correct. Pet false statement, they could be fined up to $250,000 or imprisoned for up to 5 years, or both.
18 U.S.C. §§ 152 and 3571. If relief is not ordered, the court may award attorneys' fees, costs, damages, and p

Petitioners or Petitioners' Representative

✘ _____
Signature of petitioner or representative, including representative's title

_____
Printed name of petitioner

Date signed _____
MM / DD / YYYY

Mailing address of petitioner

_____
Number Street

_____
City State ZIP Code

If petitioner is an individual and is not represented by an attorney:

Contact phone _____

Email _____

Name and mailing address of petitioner's representative, if any

_____
Name

_____
Number Street

_____
City State ZIP Code

Attorneys

✘ _____
Signature of attorney

_____
Printed name

_____
Firm name, if any

_____
Number Street

_____
City

Date signed _____
MM / DD / YYYY

Contact phone _____

Debtor _____ Case number (*if known*)_____

✘ _____
Signature of petitioner or representative, including representative's title

_____
Printed name of petitioner

Date signed _____
MM / DD / YYYY

Mailing address of petitioner

_____
Number Street

_____
City State ZIP Code

Name and mailing address of petitioner's representative, if any

_____
Name

_____
Number Street

_____
City State ZIP Code

✘ _____
Signature of Attorney

_____
Printed name

_____
Firm name, if any

_____
Number Street

_____
City State ZIP Code

Date signed _____
MM / DD / YYYY

Contact phone _____ Email _____

✘ _____
Signature of petitioner or representative, including representative's title

_____
Printed name of petitioner

Date signed _____
MM / DD / YYYY

Mailing address of petitioner

_____
Number Street

_____
City State ZIP Code

Name and mailing address of petitioner's representative, if any

_____
Name

_____
Number Street

_____
City State ZIP Code

✘ _____
Signature of Attorney

_____
Printed name

_____
Firm name, if any

_____
Number Street

_____
City State ZIP Code

Date signed _____
MM / DD / YYYY

Contact phone _____ Email _____

Print Save As... Add Attachment Reset

OFFICIAL FORM 205
INVOLUNTARY PETITION AGAINST A NON-INDIVIDUAL

Fill in this information to identify the case:

United States Bankruptcy Court for the:

_____ District of _____
(State)

Case number (*If known*): _____ Chapter _____

❑ Check if this i
amended filin

Official Form 205

Involuntary Petition Against a Non-Individual 12/15

Use this form to begin a bankruptcy case against a non-individual you allege to be a debtor subject to an involuntary case. If you want to begi a case against an individual, use the *Involuntary Petition Against an Individual* (Official Form 105). Be as complete and accurate as possible. I more space is needed, attach any additional sheets to this form. On the top of any additional pages, write debtor's name and case number (if known).

Part 1: Identify the Chapter of the Bankruptcy Code Under Which Petition Is Filed

1. **Chapter of the Bankruptcy Code**

Check one:

❑ Chapter 7
❑ Chapter 11

Part 2: Identify the Debtor

2. **Debtor's name** _____

3. **Other names you know the debtor has used in the last 8 years**

Include any assumed names, trade names, or *doing business as* names.

_____
_____
_____

4. **Debtor's federal Employer Identification Number (EIN)**

❑ Unknown

__ __ – __ __ __ __ __ __ __
EIN

5. **Debtor's address**

Principal place of business

_____
Number Street

_____

_____ _____ _____
City State ZIP Code

_____
County

Mailing address, if different

_____
Number Street

_____
P.O. Box

_____ _____ _____
City State ZIP Code

Location of principal assets, if different from principal place of business

_____
Number Street

_____

_____ _____ _____
City State ZIP Code

Debtor _____ Case number *(if known)*_____
Name

6.	**Debtor's website** (URL)	_____
7.	**Type of debtor**	❑ Corporation (including Limited Liability Company (LLC) and Limited Liability Partnership (LLP)) ❑ Partnership (excluding LLP) ❑ Other type of debtor. Specify: _____
8.	**Type of debtor's business**	*Check one:* ❑ Health Care Business (as defined in 11 U.S.C. § 101(27A)) ❑ Single Asset Real Estate (as defined in 11 U.S.C. § 101(51B)) ❑ Railroad (as defined in 11 U.S.C. § 101(44)) ❑ Stockbroker (as defined in 11 U.S.C. § 101(53A)) ❑ Commodity Broker (as defined in 11 U.S.C. § 101(6)) ❑ Clearing Bank (as defined in 11 U.S.C. § 781(3)) ❑ None of the types of business listed. ❑ Unknown type of business.
9.	**To the best of your knowledge, are any bankruptcy cases pending by or against any partner or affiliate of this debtor?**	❑ No ❑ Yes. Debtor _____ Relationship _____ District _____ Date filed _____ Case number, if known_____ MM / DD / YYYY Debtor _____ Relationship _____ District _____ Date filed _____ Case number, if known_____ MM / DD / YYYY

Part 3: Report About the Case

10.	**Venue**	*Check one:* ❑ Over the last 180 days before the filing of this bankruptcy, the debtor had a domicile, principal place of business, or principal assets in this district longer than in any other district. ❑ A bankruptcy case concerning debtor's affiliates, general partner, or partnership is pending in this district.
11.	**Allegations**	Each petitioner is eligible to file this petition under 11 U.S.C. § 303(b). The debtor may be the subject of an involuntary case under 11 U.S.C. § 303(a). *At least one box must be checked*: ❑ The debtor is generally not paying its debts as they become due, unless they are the subject of a bona fide dispute as to liability or amount. ❑ Within 120 days before the filing of this petition, a custodian, other than a trustee, receiver, or an agent appointed or authorized to take charge of less than substantially all of the property of the debtor for the purpose of enforcing a lien against such property, was appointed or took possession.
12.	**Has there been a transfer of any claim against the debtor by or to any petitioner?**	❑ No ❑ Yes. Attach all documents that evidence the transfer and any statements required under Bankruptcy Rule 1003(a).

Debtor _____ Case number (*if known*)_____
Name

13. Each petitioner's claim	Name of petitioner	Nature of petitioner's claim	Amount of the claim above the value of any lien
	_____	_____	$ _____
	_____	_____	$ _____
	_____	_____	$ _____
		Total of petitioners' claims	$ _____

If more space is needed to list petitioners, attach additional sheets. Write the alleged debtor's name and the case number, if known, at the top of each sheet. Following the format of this form, set out the information required in Parts 3 and 4 of the form for each additional petitioning creditor, the petitioner's claim, the petitioner's representative, and the petitioner's attorney. Include the statement under penalty of perjury set out in Part 4 of the form, followed by each additional petitioner's (or representative's) signature, along with the signature of the petitioner's attorney.

Part 4: Request for Relief

WARNING -- Bankruptcy fraud is a serious crime. Making a false statement in connection with a bankruptcy case can result in fines up to $500,000 or imprisonment for up to 20 years, or both. 18 U.S.C. §§ 152, 1341, 1519, and 3571.

Petitioners request that an order for relief be entered against the debtor under the chapter of 11 U.S.C. specified in this petition. If a petitioning creditor is a corporation, attach the corporate ownership statement required by Bankruptcy Rule 1010(b). If any petitioner is a foreign representative appointed in a foreign proceeding, attach a certified copy of the order of the court granting recognition.

I have examined the information in this document and have a reasonable belief that the information is true and correct.

Petitioners or Petitioners' Representative

Name and mailing address of petitioner

_____
Name

_____
Number Street

_____ _____ _____
City State ZIP Code

Name and mailing address of petitioner's representative, if any

_____
Name

_____
Number Street

_____ _____ _____
City State ZIP Code

I declare under penalty of perjury that the foregoing is true and correct.

Executed on _____
MM / DD / YYYY

✘ _____
Signature of petitioner or representative, including representative's title

Attorneys

_____
Printed name

_____
Firm name, if any

_____
Number Street

_____ _____ _____
City State ZIP Code

Contact phone _____ Email _____

Bar number _____

State _____

✘ _____
Signature of attorney

Date signed _____
MM / DD / YYYY

Debtor _____ Name

Case number (*if known*)_____

Name and mailing address of petitioner

_____ Name

_____ Number Street

_____ City _____ State _____ ZIP Code

Name and mailing address of petitioner's representative, if any

_____ Name

_____ Number Street

_____ City _____ State _____ ZIP Code

I declare under penalty of perjury that the foregoing is true and correct.

Executed on _____ MM / DD / YYYY

✘ _____ Signature of petitioner or representative, including representative's title

_____ Printed name

_____ Firm name, if any

_____ Number Street

_____ City _____ State _____ ZIP Code

Contact phone _____ Email _____

Bar number _____

State _____

✘ _____ Signature of attorney

Date signed _____ MM / DD / YYYY

Name and mailing address of petitioner

_____ Name

_____ Number Street

_____ City _____ State _____ ZIP Code

Name and mailing address of petitioner's representative, if any

_____ Name

_____ Number Street

_____ City _____ State _____ ZIP Code

I declare under penalty of perjury that the foregoing is true and correct.

Executed on _____ MM / DD / YYYY

✘ _____ Signature of petitioner or representative, including representative's title

_____ Printed name

_____ Firm name, if any

_____ Number Street

_____ City _____ State _____ ZIP Code

Contact phone _____ Email _____

Bar number _____

State _____

✘ _____ Signature of attorney

Date signed _____ MM / DD / YYYY