Bankruptcy Basics

Michael A. Sweet, Partner and Chair, Financial Restructuring and Bankruptcy Department
T: 415.364.5560
msweet@foxrothschild.com

Brian R. Anderson
T: 336.378.5205
branderson@foxrothschild.com

Deana A. Labriola
T: 919.719.1251
dlabriola@foxrothschild.com

I. The Bankruptcy Basics

A bankruptcy case begins when either a debtor files a voluntary petition for relief with the Clerk of the Federal Bankruptcy Court voluntary, or creditors initiate the process by filing an involuntary petition. Upon the commencement of a bankruptcy case a bankruptcy estate is created and a stay arises against enforcing almost every type of pre-bankruptcy claim against the debtor or the estate.

A. The Bankruptcy Code (11 U.S.C. §§ 101 – 1330)

1. The Bankruptcy Code, 11 U.S.C. §101, *et seq.*, along with the case law interpreting it, is the federal law that governs every aspect of a debtor's case in bankruptcy and of a creditor's rights with respect to a debtor and his, her or its property.

B. Primary Avenues of Available Bankruptcy Relief

1. Chapter 7 – Liquidations

a. Chapter 7 of the Bankruptcy Code, commonly referred to as a "straight" bankruptcy, involves the liquidation of a debtor's non-exempt assets with the proceeds distributed to the debtor's secured and unsecured creditors.

b. In a Chapter 7 case, a trustee is appointed. The trustee is charged with collecting and reducing to money "property of the estate."

c. "Property of the estate," as defined by Section 541 of the Bankruptcy Code, 11 U.S.C. §541, comprises all legal and equitable interests of the debtor in property, wherever located, as of the date the case is filed. Causes of action are also included in this definition.

d. The trustee directs the debtor to surrender all assets that he owns or has an interest in, except those assets (i) that are declared exempt under the Bankruptcy Code, or (ii) for which no equity exists. This latter property, which encompasses assets fully encumbered by creditor liens, is usually abandoned to the debtor, either upon motion of a party-in-interest, or later, when the case is fully administered pursuant to Section 554 of the Bankruptcy Code.

e. The Bankruptcy Code provides the trustee with an arsenal of avoidance powers that enable him/her to set aside certain transactions or transfers for the benefit of the debtor's estate. The avoidance powers are set forth in Sections 544, 545, 546, 547, 548 and 549 of the Bankruptcy Code. Among these avoidance powers are those associated with recovering preferential payments made to secured or unsecured creditors. The trustee can also avoid fraudulent conveyances. [See Preferences and Fraudulent Transfers below.]

f. Section 544(a) provides that the trustee has, as of the commencement of a case and without regard to any knowledge of the trustee or of any creditor, the rights and powers to avoid any transfer of the debtor's property or any obligation incurred by the debtor by:

A. a hypothetical judicial lien creditor as of the commencement of the case;

B. a hypothetical creditor with a writ of execution against the debtor as of the commencement of the case, which writ is returned unsatisfied at such time; and

C. a hypothetical bona fide purchaser of real property, other than fixtures, from the debtor, as of the commencement of the case, as against whom applicable law permits such transfer to be perfected.

2. Chapter 11 – Business Reorganizations

a. Unless a trustee is specifically appointed, the debtor generally retains possession of its assets, operates its business in the ordinary course and acts as a trustee and fiduciary for the benefit of its creditors (§§ 1107 and 1108). The debtor also retains the avoidance powers set forth in Sections 544, 545, 546, 547, 548 and 549 of the Bankruptcy Code.

b. Chapter 11 was designed to allow businesses to reorganize their financial affairs through the confirmation of a plan of reorganization (§§ 1123 and 1129), However, it is oftentimes used by the debtor to self liquidate, including the sale of the debtor's assets (§ 363) as a going concern to maximize value for creditors. Chapter 11 is also available to individual debtors.

c. A debtor has the exclusive right to file a plan within the first 120 days from the entry of the order for relief. This period may be extended by the Bankruptcy Court, but this period cannot be extended beyond 18 months.

d. Small Business Debtors. The Bankruptcy Code allows small business debtors to file for relief under two different special categories of chapter 11 intended to streamline processes and reduce costs. The first, referred to as a small business case (by definition in 11 U.S.C. § 101(51C)), was created in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), and the second, referred to as subchapter V, was created in 2019 by the Small Business Reorganization Act (SBRA). A debtor may elect either of these two options based on certain eligibility criteria. Both small business and subchapter V cases are treated differently than a traditional chapter 11 case primarily due to accelerated deadlines and the speed with which the plan is confirmed.

A. Small Business The two types of cases have different debt limits, defined as the total amount of noncontingent liquidated secured and unsecured debt at the time

the debtor files their bankruptcy case. In order to file a small business case the debtor must be engaged in commercial or business activities (other than primarily owning or operating a single piece of real property) with total noncontingent liquidated secured and unsecured debts of $2,725,625 or less, not less than 50 percent of which arose from the commercial or business activities of the debtor. Eligibility for subchapter V uses the same standard, but a different debt limit. When the SBRA was first passed, the debt limit threshold to be a debtor under subchapter V was the same as a small business case ($2,725,625). However, the Coronavirus Aid, Relief, and Economic Security (CARES) Act, enacted in March 2020 in response to the coronavirus (COVID-19) pandemic, temporarily increased the debt limit for subchapter V cases to $7,500,000. 11 U.S.C. § 1182(1)(A). The temporarily increased debt limit for subchapter V cases was recently extended.

B. No Committee. In addition to accelerated deadlines and faster plan confirmation, small business and subchapter V cases have other key differences from ordinary chapter 11 cases: a creditors' committee is not automatically appointed and instead will only be appointed upon a showing of cause, 11 U.S.C. § 1102(a)(3), and the debtor or debtor in possession has additional duties, 11 U.S.C. § 1116.

C. Financial Reporting. In both small business cases and subchapter V cases, the debtor must, among other things, attach its most recent balance sheet, statement of operations, cash-flow statement and Federal income tax return to the petition, or provide a statement under oath explaining the absence of such documents, and must attend meetings scheduled by the court or the U.S. trustee through senior management personnel and counsel. The debtor must make ongoing filings with the court concerning its profitability and projected cash receipts and disbursements and must report whether it is in compliance with the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure and whether it has paid its taxes and filed its tax returns. 11 U.S.C. §§ 308, 1116, 1187.

D. Subchapter V Trustee. In a subchapter V case, a trustee will be appointed to administer the debtor's estate and oversee its reorganization. The trustee's role in a subchapter V case is similar to that of a chapter 12 or 13 trustee: facilitating the development of and overseeing the debtor's plan of reorganization; appearing at major hearings; investigate the debtor's conduct, assets and liabilities, financial condition, and the operation of the debtor's business as a going concern; and ensuring that payments are made under the plan. 11 U.S.C. § 1183. The U.S. trustee has the same oversight responsibilities as ordinary chapter 11 cases. 28 U.S.C. § 586.

E. Plan Filing Deadlines. Because certain filing deadlines are different and extensions are more difficult to obtain, a small business case normally proceeds more quickly than other chapter 11 cases. In a small business case, only the debtor may file a

plan during the first 180 days after the case is filed. 11 U.S.C. § 1121(e). This "exclusivity period" may be extended by the court, but only to 300 days, and only if the debtor demonstrates by a preponderance of the evidence that the court will confirm a plan within a reasonable period of time. In a subchapter V small business case, only the debtor may file a plan. 11 U.S.C. § 1189. In other chapter 11 cases, however, the court may extend the exclusivity period "for cause" up to 18 months. Another example of the faster pace of small business and subchapter V cases is that the debtor may not need to file a separate disclosure statement if the court determines that adequate information is contained in the plan. 11 U.S.C. §§ 1125(f), 1181, 1187. In a traditional chapter 11 case, the debtor must file a separate disclosure statement. 11 U.S.C. § 1125.

Easier to Cram Down on Secured Lenders. Subchapter V cases go beyond other chapter 11 and small business cases by allowing for relaxed plan confirmation requirements. No need for accepting class of impaired creditors. Plans can be confirmed as long as they do not discriminate unfairly, are fair and equitable with respect to each class of claims or interests, provide that all projected disposable income of the debtor (or equivalent value) is paid into the plan for a three to five year period. 11 U.S.C. § 1191.

e. Single Asset Real Estate Debtor. Single asset real estate debtors are subject to special provisions of Chapter 11 of the Bankruptcy Code.

A. Single Asset Real Estate Defined. The term "single asset real estate" is defined as "a single property or project, other than residential real property with fewer than four residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental." 11 U.S.C. § 101(51B).

B. Relief from Stay. The Bankruptcy Code provides circumstances under which creditors of a single asset real estate debtor may obtain relief from the automatic stay which are not available to creditors in ordinary bankruptcy cases. 11 U.S.C. § 362(d). On request of a creditor with a claim secured by the single asset real estate and after notice and a hearing, the court will grant relief from the automatic stay to the creditor unless the debtor (1) files a feasible plan of reorganization, or (2) begins making interest payments to the creditor within 90 days from the date of the filing of the case, or within 30 days of the court's determination that the case is a single asset real estate case. The interest payments must be equal to the non-default contract interest rate on the **value of the creditor's interest** in the real estate. 11 U.S.C. § 362(d)(3).

C. Single asset real estate cases are ineligible for the small business or subchapter V election. 11 U.S.C. § 101(51D), 1182(1)(A).

f. Appointment of a Trustee. Although the appointment of a case trustee is a rarity in a chapter 11 case, a party in interest or the U.S. trustee can request the appointment of a case trustee or examiner at any time prior to confirmation in a chapter 11 case. The court, on motion by a party in interest or the U.S. trustee and after notice and hearing, shall order the appointment of a case trustee for cause, including fraud, dishonesty, incompetence, or gross mismanagement, or if such an appointment is in the interest of creditors, any equity security holders, and other interests of the estate. 11 U.S.C. § 1104(a). Moreover, the U.S. trustee is required to move for appointment of a trustee if there are reasonable grounds to believe that any of the parties in control of the debtor "participated in actual fraud, dishonesty or criminal conduct in the management of the debtor or the debtor's financial reporting." 11 U.S.C. § 1104(e). The trustee is appointed by the U.S. trustee, after consultation with parties in interest and subject to the court's approval. Fed. R. Bankr. P. 2007.1. Alternatively, a trustee in a case may be elected if a party in interest requests the election of a trustee within 30 days after the court orders the appointment of a trustee. In that instance, the U.S. trustee convenes a meeting of creditors for the purpose of electing a person to serve as trustee in the case. 11 U.S.C. § 1104(b).

A. The case trustee is responsible for management of the property of the estate, operation of the debtor's business, and, if appropriate, the filing of a plan of reorganization. Section 1106 of the Bankruptcy Code requires the trustee to file a plan "as soon as practicable" or, alternatively, to file a report explaining why a plan will not be filed or to recommend that the case be converted to another chapter or dismissed. 11 U.S.C. § 1106(a)(5).

B. Upon the request of a party in interest or the U.S. trustee, the court may terminate the trustee's appointment and restore the debtor in possession to management of bankruptcy estate at any time before confirmation.11 U.S.C. § 1105.

C. A trustee is appointed in each subchapter V case. However, the role of a subchapter V trustee is more circumscribed, focusing on the development and implementation of a subchapter V plan, rather than the role of a traditional chapter 7 trustee to liquidate assets and pursue claims.

g. Conversion or Dismissal. A party may file a motion to dismiss or convert a chapter 11 case to a chapter 7 case "for cause." Generally, if cause is established after notice and hearing, the court must convert or dismiss the case (whichever is in the best interests of creditors and the estate) unless it specifically finds that the requested conversion or dismissal is not in the best interest of creditors and the estate. 11 U.S.C. § 1112(b). Alternatively, the court may decide that appointment of a chapter 11 trustee or an examiner is in the best interests of creditors and the estate. 11 U.S.C. § 1104(a)(3). Section 1112(b)(4) of the

Bankruptcy Code sets forth numerous examples of cause that would support dismissal or conversion. For example, the moving party may establish cause by showing that there is substantial or continuing loss to the estate and the absence of a reasonable likelihood of rehabilitation; gross mismanagement of the estate; failure to maintain insurance that poses a risk to the estate or the public; or unauthorized use of cash collateral that is substantially harmful to a creditor. Cause for dismissal or conversion also includes an unexcused failure of timely compliance with reporting and filing requirements; failure to attend the meeting of creditors or attend an examination without good cause; failure to timely provide information to the U.S. trustee; and failure to timely pay post-petition taxes or timely file post-petition returns Fed. R. Bankr. P. 2004. Additionally, failure to file a disclosure statement or to file and confirm a plan within the time fixed by the Bankruptcy Code or order of the court; inability to effectuate a plan; denial or revocation of confirmation; inability to consummate a confirmed plan represent "cause" for dismissal under the statute. In an individual case, failure of the debtor to pay post-petition domestic support obligations constitutes "cause" for dismissal or conversion.

3. Chapter 13 - Plans For Individuals With Regular Income

a. Chapter 13 is an alternative for individuals and is utilized in most cases to permit the debtor to keep its non-exempt assets (in particular, the debtor’s home).

b. In order to qualify as a Chapter 13 debtor, the debtor must have less than $419,275 of unsecured debt and less than $1,257,850 of secured debt. The automatic stay generally applies to certain consumer co-debtors as well.

c. The debtor agrees to reimburse its creditors from a future flow of income, payable over the later of full payment to creditors or 5 years of the debtors “disposable income.” The Plan must be filed within a prescribed time period (within 15 days of filing the petition), and confirmed by the court. The unsecured creditors must receive the greater of what they would have received had the debtor filed a Chapter 7. The Plan must be filed in "good faith" and must pass a feasibility test (i.e., the debtor's ability to fund the Plan).

d. A Chapter 13 debtor can force the secured creditor to allow the debtor to retain the collateral even if there is a significant amount of arrearage.

C. Creditor Committees

1. Section 1102 says that "as soon as practicable after the order for relief … the United States Trustee shall appoint a committee of creditors…." Section 1103(c) sets forth a detailed catalog of committee powers.

2. Small Business Cases. Generally no Committee is appointed.

3. Committee professionals. In those cases where the numbers justify it, the committee may play an important role. The committee may employ counsel (and other professionals). Like the debtor's counsel, the committee counsel may be paid as administrative claimants out of assets of the estate. A well-organized committee of sophisticated creditors, speaking through a competent counsel, can play a major part in shaping a case and sometimes even dominate a case. In addition, committee members are authorized to receive reimbursement of expenses from the estate, but they are not compensated as "professionals."

4. Judges often like committees. The judge may be eager for another voice, either to challenge or (where appropriate) to confirm what the debtor is telling him. Moreover, lawyers for the committee often find they have a freer hand than lawyers for the debtor.

5. Chapter 7 Committees. There is also a provision for a committee of creditors in chapter 7, but such committees are rarely constituted because the cases tend to be smaller and creditors do not have anything to gain from adding another layer. One important distinction is that the chapter 7 committee is not appointed but elected (just like the equally rare "elected" chapter 7 trustee).

6. Committee Obligations. Committees are required to share information with and receive comments from members of their constituency who are not on the committee. This makes sense as a way to assure that the committee is representing its constituency's interests, but it raises concerns about maintaining privileges and dealing with the sort of confidential and sensitive information to which committees often have access to. In some cases, a committee will file a motion seeking approval of procedures for complying with these new requirements and protections relating to confidentiality and privilege.

7. Limits on Committee Membership.

    a. There is a downside to committee service. For example, Pan Am World Airways commenced a chapter 11 petition in 1991. Delta Air Lines undertook interim financing and bought some Pan Am routes while negotiating for a broader role. Hoping to keep the airline viable, some unions agreed to concessions. But the deal broke down and the employees howled betrayal, perceiving that Delta had kept Pan Am alive only long enough to skim off the good assets. Thereupon, the employees sued Delta for $2.5 billion. By way of defense, Delta sought to implead members of the Pan Am creditors' committee, alleging that the committee displaced the debtor in plan negotiations. In response, committee members asserted that they had immunity from suit. The judge, conceding that they had limited immunity, nonetheless found that the complaint alleged willful wrongdoing and thereby survived a motion to dismiss.

    b. Committee members may also be restricted in or barred from claims trading or trading in securities of the debtor. In some cases, courts have approved "ethical screening" mechanisms so that committee member institutions could continue to trade by separating

those who serve on the committee (and therefore have access to nonpublic information) from those at the member institution who do the trading.

8. Additional Committees.

   a. The court may (but is not required to) appoint additional committees - either of creditors or of equity security holders. The court shall order such additional committees "if necessary to assure adequate representation of creditors or of equity security holders." After a court order, it is left to the U.S. Trustee in the first instance to appoint such committees.

   b. Aside from equity committees, we have seen committees appointed to speak for such various constituencies as: subordinated debtholders, employees, personal injury plaintiffs, limited partners and retirees.

9. Committee Membership

   a. The Code provides that a committee of creditors "shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee. . . ." But the Code also allows the U.S. Trustee to carry over a pre-petition committee "if such committee was fairly chosen and is representative of the different kinds of claims to be represented." This provision allows creditors to organize and negotiate with the debtor outside chapter 11, carrying some expectation that they will be able to continue after the petition. On occasion, a creditor is unhappy with the U.S. Trustee's decision about who gets appointed to the committee or who does not. The court may order the U.S. Trustee to change the committee's composition order to assure adequate representation.

D. Secured Claims

1. Allowance and Amount of Secured Claims.

   a. Bifurcation. Section 506 governs the amount of a secured claim. It provides that the amount of a claim is secured only to the extent of the value of the collateral securing the claim. The balance of an under-secured claim is deemed to be an unsecured claim.

      i. Valuation. There are basically three standards: 1. What the secured creditor could obtain during foreclosure, 2. What the debtor would have to pay to replace the collateral, and 3. A middle point between foreclosure and replacement value;

ii. Section 506(a) provides that the valuation shall be determined "in light of the purpose of the valuation and the proposed disposition or use", so the court is not bound by the same valuation in all aspects of the case.

b. Interest, Fees and Costs. Generally entitled to post-petition interest only to the extent the secured creditor is oversecured (collateral value exceeds the claim amount). Reasonable fees and costs are generally allowed as a claim (secured to the extent of the value collateral and unsecured to the extent it exceeds the value).

i. Interest Rate. Most courts will allow the contract rate of interest; even the default rate if in effect, unless it is found to be excessive under the circumstances (i.e., usurious, significant impact on unsecured recovery, nature of the default)

c. Prepayments Penalties. Generally allowed as a claim to the extent determined to be reasonable. Do they represent a true and fair calculation of damages (at the time the loan agreement is entered into) or are they simply a penalty?

2. **Protecting your Collateral Pre-petition.** Is a bankruptcy looming? Is the borrower in default? Financial distress? Is the loan maturing without prospects of refinancing? Time to review your loan files and collateral for weaknesses:

a. Is there a proper grant of a security interest? Does it include proceeds and products? After-Acquired Property?

b. Are your liens properly perfected?

c. Are there intervening liens? Taxes? Mechanic's Liens?

d. Is your collateral properly insured?

e. Do you have access to the collateral? Landlord's waiver and access agreements? Deposit account control agreements?

f. Can corrections be made? Unilaterally? With the Borrower's help? Even if it might be a preference (if there is a BK filing), corrections should be made!

g. Timing issues. If corrective measures are taken, you may want to consider postponing/forbearance of certain collection/enforcement actions to mitigate potential avoidance actions in bankruptcy

3. **Adequate Protection Post-Petition.** The Bankruptcy Code affords adequate protection to secured creditors and is intended to protect the value of their security interests. If a debtor wants

to use encumbered property, then the debtor must protect the secured creditor's secured interests from a decline in value.

a. Relief from Stay. Lack of adequate protection is cause for providing a lift of the automatic stay as to the secured creditor and its collateral. Debtor has the burden of proof that the collateral is adequately protected.

b. Section 507(b) Administrative Claim: When adequate protection fails, a secured creditor is entitled to an administrative claim for the diminution in the value of its secured interest. However, a secured creditor is entitled to such administrative claim only if the court previously ordered the debtor to provide protection and such protection failed. (i.e. an order entered in response to a motion for an order of relief from the automatic stay and/or an order requiring adequate protection).

c. What Constitutes Adequate Protection?

   i. Equity Cushions (if substantial)

   ii. Cash Payments

   iii. Replacement Liens

   iv. Maintenance and Insurance (usually this is the minimum and included as a part of the adequate protection)

   v. Payment of post-petition property taxes or first lien post-petition interest and fees

   vi. Third-Party Guarantees – depending on the financial strength of the guarantor

4. **Use of Collateral Post-petition.** A debtor can generally use collateral in the *ordinary course of business* without court approval; except for cash collateral.

a. Cash Collateral. Cash collateral cannot be used by a debtor unless (1) the secured creditor consents, or (2) the court, after notice and a hearing grants authority upon a showing of adequate protection.

b. Use of Collateral Outside of the Ordinary Course. Only upon court approval after notice and a hearing.

c. Ordinary Course: (1) a type of transaction that other similar business would engage in as ordinary business (not unusual for the industry) and (2) the transaction does not subject

secured creditors to economic risk different from those risks accepted when the secured creditors agreed to extend credit to the debtor.

d. Sale of Assets Free and Clear. A debtor can sell collateral outside of the ordinary course of business and free and clear of liens and other interests, if the sale passes the Business Judgment Test **and** if one of the following five (5) occurrences exist:

   i. Applicable nonbankruptcy law permits such sale (very limited use, i.e. sale of an auto where secured interest is not noted on the title);

   ii. Secured Creditors Consent (your failure to object may be considered consent in some jurisdictions);

   iii. Net Sale Price is "greater than" the value of the liens. Some courts interpret this to mean that the property is sold for a price that accurately reflects the value of the asset sold (the secured portion of the liens), while others have interpreted this to mean the total face amount of the liens holders;

   iv. If the liens and/or interests are in bona fide dispute;

   v. The sale free and clear of an "interest" if the interest holder could be compelled to accept a money satisfaction of that interest;

e. As part of adequate protection, the liens of secured creditors attach to the proceeds of the sale of the assets.

f. Credit Bidding. Sections 3636(k) and 1129(b)(2)(A)(ii) each preserves the right of a secured creditor to credit bid at the sale of its collateral, unless the court *for cause* orders otherwise.

   i. Deny the right to credit bid *for cause* is a rare exception but may include situations were the court finds that credit bidding will unduly chill the bidding process or were the lien is in dispute or where the secured party does not have a lien on a material portion of the assets being sold.

5. **Chapter 11 Plans:** One of the fundamental goals of a debtor is to formulate a plan that is confirmed by the bankruptcy court. It can also be a driving force that simply keeps the case alive. Plans can provide for the reorganization of the debtor business as a going concern or can simply provide for an orderly liquidation. The bankruptcy code contains many criteria for a plan to be confirmed (i.e. fair and equitable, absolute priority test and the liquidation test), but often the biggest hurdle is the acceptance of the plan, via the voting process, by creditors.

a. Chapter 11 Plan Voting Basics:

i. Classes. Claims are put into different classes and the classes vote to accept or reject the plan;

ii. Acceptance. A class is deemed to have accepted the plan if the holders of claims equaling at least two thirds (2/3) in amount and more than one half (1/2) in number (of the those claims that actually voted in said class) vote to accept the plan. Note that insider claim votes do not count toward the acceptance of a plan. If all classes accept the plan, the plan can be confirmed.

iii. Cram Down. The Bankruptcy Code also allows for confirmation of the plan in the absence of all Class acceptances. Under appropriate circumstances, a plan that is not accepted by all classes of impaired creditors and interest holders may still be confirmed by the court (crammed down the dissenting creditors), if there is at least one impaired Class that accepts the plan and the plan is deemed fair and equitable.

b. Classification of Secured Claims.

i. Secured portion in one class/unsecured portion in another class

ii. In some jurisdictions the unsecured portion can be separately classified (in its own class) – separate and apart from other unsecured claims (and sometimes even separate from other under-secured claims of other lenders, which will have their own class)

iii. Some jurisdictions allow certain claims that are guaranteed by third parties to be separately classified.

iv. In some jurisdictions the unsecured portion of a secured lender's claim must be in the same class as other unsecured claims. This often makes certain plans unconfirmable, since a large under-secured creditor may control all voting classes.

c. Not all classes of unsecured claims need to be paid pro-rata. Certain essential unsecured trade creditors may also be separately classified and afforded different (better) treatment than the under-secured portion of a secured creditor's claim. These are often times the consenting Class of creditors in a cram down situation.

d. 1111(b) Election. Allows an under-secured secured creditor the option of treating its claim as fully secured rather than splitting into secured and unsecured claims (and classes). Must

then be paid over time an amount (1) that is not less than the present value of the value of the collateral and (2) the total of which equals the total amount of its full claim.

i. Often used as an economic roadblock to plan confirmation (simply because the math does not work for the debtor).

ii. Creditors may also choose 1111(b) to preserve the full amount of their claim in hopes of the market for the collateral rebounding and the debtor later defaulting under the plan.

E. Priority of claims

1. Unless agreed otherwise claims against the Debtor's estate will receive a distribution based upon a priority scheme set forth in Section 507 of the Code:

   a. Secured Claims – Lenders get the **value** of their collateral

   b. Administrative Claims:

      i. Incurred during the case, or

      ii. Section 503(b)(9) claims for goods received by the debtor within 20 days of the commencement of a case and sold in the ordinary course of business.

   c. Priority Claims:

      i. Up to $12,850.00 per claimant for salary, commission or wages earned within 180 days of filing case,

      ii. Employee benefits earned within 180 days of filing case [total of benefit claims are capped $12,850.00 times number of employees, less the amounts paid for salary, wages or commissions],

      iii. Up to $2,850.00 per consumer for deposits of money for consumer goods

      iv. Certain tax claims

   d. General unsecured claims

   e. Equity

2. Absolute Priority Rule: Every higher priority claim must be paid in full before any lower priority claim gets paid 1¢.

F. Filing Proof of Claim

1. Should Secured Credits File a Proof of Claim? Short answer: YES

   Secured Creditors do not have to file a Proof of Claim, but they should. By filing a proof of claim you are subjecting yourself to the jurisdiction of the court, but there are also many instances where a secured creditor will want/need to participate in the case (i.e. the plan process, sale of assets, use of its collateral, etc.). Also, if you are under-secured (your collateral is worth less than your claim) then you may need a proof of claim to have an unsecured (deficiency claim) and also share as an unsecured creditor.

2. In order to share in any distribution of liquidated assets or money, a creditor must file a proof claim in all Chapter 7, 12, and 13 cases, especially where the trustee has notified creditors of the likelihood of a distribution of assets ("no asset case" vs. "asset case"). Proofs of claim must be filed within 70 days after the petition is filed commencing the case (unless the trustee instructs you otherwise in writing/notice). [Bankruptcy Rule 3002].

3. While it is not always necessary for a creditor to file a proof of claim in a Chapter 11 case, it is advisable. There is no statutory deadline. The deadline will be set by court order upon motion (usually filed by the debtor). In a Chapter 11 case, a proof of claim is deemed filed if the debt is scheduled and is not listed as disputed, contingent, or unliquidated. (**§** 1111(a)). But, keep in mind that the debtor's schedules can be amended during the case.

4. Once the proof of claim is filed, the claim is deemed allowed unless there is an objection. (§502(a)) Failure to timely file a proof of claim may be excused by the court only upon a showing of "excusable neglect." This is an extremely difficult standard to overcome. (Bankruptcy Rule 9006(b)(1))

G. The Automatic Stay (§ 362) – Giving the Debtor a Breathing Spell from Collection Efforts During the Bankruptcy

1. Broad In Scope To Protect The Debtor And Its Property (§ 362(a))

   a. Prohibits the commencement or continuation of any prepetition action against the debtor (i.e. stops any pending actions or post-judgment procedures) (§ 362(a)(1)).

b. Prohibits any act to obtain possession of or exercise control over property of the estate (i.e. stops any attempt to take possession of leased or mortgaged premises) (§ 362(a)(3)) [including actions to repossess collateral, acting upon a power of sale or foreclosure, or notifying account debtors pursuant to the Uniform Commercial Code].

   A. Section 541 of the Bankruptcy Code, 11 U.S.C. §541, provides that the commencement of a bankruptcy case creates an estate. Property of the estate comprises all legal and equitable interests of the debtor in property, wherever located, as of the date of the case is commenced. The provision is very broad and includes all kinds of property, both tangible and intangible, including causes of action and claims by the debtor against others.

c. Prohibits any act to create, perfect or enforce any lien against property of the estate (§ 362(a)(4)).

d. Prohibits any act to collect, assess, or recover a prepetition claim against the debtor (i.e. stops any further notices or demands in regard to prepetition claims) (§ 362(a)(6)).

e. Prohibits the setoff of any debt owing to the debtor that arose before the commencement of the case against any claim against the debtor (§ 362(a)(7)). However, it does not apply to a creditor's right of recoupment.

   A. §362(a)(7) does not abrogate a creditor's right of setoff, which is recognized in Sections 363, 506 and 553 of the Bankruptcy Code. Rather, §362(a)(7) requires the creditor to first obtain relief from the automatic stay.

   B. Recoupment means a right to reduce the amount of a claim, but does not involve independent obligations. By definition, recoupment can arise only out of the same transaction or occurrence that gives rise to the liability sought to be reduced.

2. But The Automatic Stay Is Not Without Exceptions (§ 362(b))

a. It does not operate as a stay of the commencement or continuation of a criminal action or proceeding against the debtor (§ 362(b)(1)). This provision memorializes the deep conviction that federal bankruptcy courts should not interfere with state criminal prosecutions. However, some courts have held that this exception to the automatic stay does not apply if the criminal proceeding has the collection of a debt as the underlying aim.

b. It does not apply to an action to collect alimony, maintenance, or support from property that is not property of the estate (§ 362(b)(2)).

c. It does not apply to acts to perfect or maintain prepetition liens with retroactive effect (i.e. prepetition mechanics/construction liens with retroactive effect may still be perfected, notice of a purchase money security interest can still be sent) (§ 362(b)(3)).

d. It does not apply to the exercise of the government's police and regulatory powers (i.e. stay prevents state and city officials from exercising their eminent domain powers, but they can still enforce building, safety and health codes and regulations) (§ 362(b)(4)).

e. It does not apply to any repossession actions by a lessor under a nonresidential real property lease that terminated by the expiration of its stated term prior to the bankruptcy (i.e. if a commercial lease has expired before the bankruptcy filing, the landlord may still repossess, but prudent practice still dictates a request to the Bankruptcy Court for relief from stay) (§ 362(b)(10)).

f. The automatic stay does not apply to the continuation of eviction actions against residential tenants if a prebankruptcy judgment of possession was obtained (§§ 362(b)(22)).

    A. This exception does not apply until 30 days after the bankruptcy filing, if the debtor has a right to cure the default and deposits any rent that would be due during those 30 days (§ 362(l)(1)).

    B. If the debtor thereafter cures the default and files a certification to that effect, the exception becomes inapplicable in its entirety (§ 362(l)(2)).

g. Landlords can "just say no" to drug dealing debtors: the automatic stay will not apply if a landlord seeks to evict a residential tenant based on endangerment of the property or drug use at the property and files a certification to that effect (§ 362(b)(23)).

    A. The exception does not apply until 15 days after the landlord files a certification that eviction is based on damage to the property or drug use (§ 362(m)(1)).

    B. If the debtor objects to the certification during that 15 day period, however, the exception does not apply until further order of the court (§ 362(m)(2)).

h. **Co-debtors.** With the exception of Chapter 13 bankruptcies involving certain co-debtors, the automatic stay is generally not available to non-bankrupt co-defendants of a debtor, even if they are in a similar legal and factual nexus with the debtor. Co-debtors such as guarantors don't get a free ride from the automatic stay: it does not generally protect non-bankrupt debtors or property of non-bankrupt debtors (i.e. co-obligors and guarantors can be pursued, and letters of credit can be drawn upon without violating the automatic stay).

A.Section 1301 of the Bankruptcy Code provides:

1. [A] creditor may not act, or commence or continue any civil action, to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor, or that secured such debt, unless

   a) such individual became liable on or secured such debt in the ordinary course of such individual's business; or

   b) the case is closed, dismissed, or converted to a case under chapter 7 or 11 of this title.

3. **Letters of Credit.** Draws upon LOCs are generally not subject to (not prohibited by) or affected by the automatic stay. An overwhelming majority of courts have held that the proceeds of a Letter of Credit are not property of the debtor or its estate (even if it has an effect on the debtor's property, i.e. if the LOC is secured by property of the debtor).

4. **The Duration of the Automatic Stay**

   a. Pursuant to Section 362(c)(1), the automatic stay of an act against property of the estate terminates on such date as such property is no longer property of the estate. The stay of any other acts under Section 362(a) continues until such time as (i) the case is closed, (ii) the case is dismissed, or (iii) if the case is a case under Chapter 7 concerning an individual, or a case under Chapters 9, 11, 12, or 13, the time a discharge has been granted or denied.

   b. If an individual debtor had another bankruptcy pending within one year of his/her current case, then Section 362(c)(3)(A) provides that the automatic stay will terminate "with respect to the debtor" thirty days after the filing. An exception to this rule is found in Section 362(c)(3)(B), which provides that a party-in interest (including the debtor) may seek an extension of the stay beyond the 30 days as to any or all creditors, if the party-in-interest successfully demonstrates that the later case was filed in good faith as to the creditors to be stayed. The hearing on the motion to extend the automatic stay must not only be held but also must be completed before the thirty day period expires.

   c. Pursuant to Section 362(c)(4), if two or more bankruptcy cases were pending against a debtor within the previous year of a new filing, but had been dismissed, other than a case re-filed under Section 707(b), the automatic stay arising under §362(a) will not go into effect upon the filing of the later case. However, if, within 30 days after the filing of the later case, a party in interest requests the court to impose the stay as to any or all of the creditors, the court may do so, but only if the party in interest demonstrates that the filing of the later case is in good faith as to the creditors to be stayed.

d. Pursuant to Section 362(h), in a case with an individual debtor, the stay provided by §362(a) will terminate with respect to personal property of the estate or of the debtor securing in whole or in part a claim, or subject to an unexpired lease, if the debtor fails within the applicable time set by §521(a)(2) (i) to timely file a statement of intention with respect to such personal property (i.e., surrender such personal property or retain it) and timely take the action specified in such statement.

5. And the Automatic Stay Can Be Lifted Or Modified Upon Request On Appropriate Grounds (§ 362(d))

a. For "cause, including the lack of adequate protection of an interest in property" (decided on a case by case basis depending upon the nature of the particular interest) (§ 362(d)(1)).

A. Lack of adequate protection is only one example of "cause" for modifying the automatic stay. In determining whether cause exists for purposes of obtaining relief from the automatic stay, courts will consider the following factors: (1) the harm to the party seeking relief from the stay if the stay is not lifted; (2) the harm to the debtor if the stay is lifted; (3) the interests of the creditors; and (4) the effect on fair and efficient administration of justice.

B. When the issue is whether to modify the automatic stay to allow for the continuance of prepetition litigation, the courts have adopted more specific factors. Courts generally have attempted to balance the potential prejudice to the debtor and the creditors of the bankruptcy estate against the hardship to the moving party if it is not allowed to proceed. In balancing these hardships, courts normally evaluate the following factors: (1) judicial economy; (2) trial readiness; (3) the resolution of preliminary bankruptcy issues; (4) the creditors' chance of success on the merits; (5) the cost of defense or other potential burdens to the bankruptcy estate, and (6) the impact of the litigation on other creditors.

b. Intended acts against debtor's property can proceed if (i) the debtor has no equity in the property (i.e. the debtor's ownership interest is underwater with liens or the debtor's leasehold interest has terminated or expired); and (ii) the property is not necessary to an effective reorganization (§ 362(d)(2)).

c. Single-asset real estate cases where (i) no confirmable plan of reorganization is filed within 90 days, or (ii) debtor has failed to make monthly payments of non-default rate interest to secured creditors (§ 362(d)(3)).

d. Procedure

A. A request for relief from the automatic stay is made by motion. (See Federal Rule of Bankruptcy Procedure 4001(a)(1)). In the Northern District of Illinois, at the time

of the filing of the motion, it must be accompanied by a statement of default, motion to modify stay.

B. Notice must be served on the debtor, the debtor's attorney, the case trustee, and any party who has requested notice of all proceedings. (Fed.R.Bankr.P. 9014). In a chapter 11 case, notice must also be served on all committees, or if there are none, then on the twenty largest unsecured creditors. (Fed.R.Bankr.P.1007(d) and 4001).

C. The stay terminates automatically 30 days after the filing of the motion for relief, unless the court enters an order continuing the stay pending conclusion of a final hearing or unless the court has entered an order denying the motion. The bankruptcy court must hold a hearing as to a request for stay relief on an expedited basis within 30 days of the filing of the motion, (§362(e)(1)). If the debtor is an individual and a debtor under chapter 7, 11 or 13, the court must render a final decision on that motion within 60 days of its being filed. (§362(e)(2)). The court may extend the stay, and deliver its decision at a date later than 60 days, or if the court finds that there is good cause to extend the period for a specific amount of time and describes that "good cause" in findings. (§362(e)(2)(B)(ii)).

1. A creditor may waive its right to have the hearing within 30 days and may waive its right to have the decision rendered within 60 days. (§362(e)(2)(B)(i)). A creditor may desire to do this if the hearing is likely to be contested and require expert testimony. Additionally, a creditor may want the extra time to try to craft a settlement agreement with the debtor for adequate protection payments or some other sort of relief.

D. Once an order for relief from the automatic stay is granted, there is an automatic 14-day waiting period before the creditor may act on the order unless the waiting period is waived by the bankruptcy court. (Fed.R.Bankr.P. 4001(a)(3)). Although the purpose of the waiting period is to give the debtor an opportunity to seek a stay pending appeal before the order becomes effective, some courts use the 14-day period as a cure period, allowing the debtor to cure any default to the secured creditor to avoid the final effect of stay modification. Some judges routinely waive the automatic 14-day stay upon a creditor's request in its motion provided there is no objection. Other judges require the creditor to show cause, such as that irreparable harm may occur if the creditor is not allowed to immediately repossess the collateral.

6. Violations of the Automatic Stay

a. The stay of §362 is "automatic" because it is triggered as against all entities upon the filing of a bankruptcy petition, irrespective of whether the parties to the proceedings stayed are

aware that a petition has been filed. It is quite possible, therefore, that a creditor might unwittingly violate the automatic stay due to the debtor's failure to provide prompt or appropriate notice of the bankruptcy case. The issue then becomes whether actions taken in violation of the stay are null and "void" and therefore incapable of being sanctioned by the bankruptcy court, or are merely "voidable" and capable of post-event ratification. Unfortunately, no consensus exists with respect to this issue.

b. Pursuant to §362(k) of the Bankruptcy Code, an "individual" injured by any willful violation of the automatic stay is entitled to recover his/her actual damages, including costs and attorney's fees. In appropriate circumstances, punitive damages are also recoverable. In determining whether a violation is "willful," so as to support an imposition of sanctions, a specific intent to violate the stay need not be established. Rather, an award of damages is permitted simply upon a finding that (i) the defendant knew the automatic stay was in place and, (ii) the defendant's action which violated the stay was intentional.

II. Preferences

A. Elements of a Preference

A transfer of an "interest of the debtor in property" made within the 90-day period preceding a bankruptcy filing by an insolvent debtor to a creditor on account of an antecedent debt can be recovered by the estate as a preference (§547(b)).

Specifically a preference under the bankruptcy code is any transfer of an interest of the debtor in property:

1) to or for the benefit of a creditor;

2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

3) made while the debtor was insolvent;

4) made

    A. on or within 90 days before the date of the filing of the petition; or

    B. between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

5) that enables such creditor to receive more than such creditor would receive if

    A. the case were a case under chapter 7 [of the Code];

    B. the transfer had not been made; and

    C. such creditor received payment of such debt to the extent provided by [the Bankruptcy Code].

1. The "interest of the debtor in property" can be money from the debtor or the creation of a lien on the debtor's property.

2. The date of the "transfer" for preference purposes is deemed to be made when the check clears the debtor's bank (not the date that the payment was received by the creditor).

3. The transfer date for a cashier's check is when the creditor obtains physical possession of the check.

4. The transfer date for a lien on a bank account is the date the turnover order is entered.

B. One Goal of Bankruptcy

One goal of bankruptcy is the orderly and fair distribution of assets to the creditors and these monies paid by the debtor to creditors during this 90-day period are to be brought back into the bankruptcy estate for redistribution to all of the creditors.

1. Both bankruptcy trustees and debtors-in-possession *(i. e.,* most chapter 11 debtors) have the obligation to file adversary proceedings to recover these monies from the creditor.

C. Preference limitations

There are threshold dollar amounts for a debtor's or trustee's suit for a preference claim against a creditor.

1. In a consumer case, if the aggregate value of all property transferred by a consumer debtor to a creditor is less than $600.00, a trustee cannot sue for recovery of the preference. (§547(c)(8)).

2. In a case where the debtor's debts are not primarily consumer debts, there is a threshold floor of $6,425.00 aggregate value of all property transferred before a preference recovery action can be brought. (§547(c)(9)).

3. Legal proceedings brought by a trustee or debtor to recover a consumer debt of less than $20,450 (recently increased from $19,250) or to recover a non-consumer debt of less than $13,650 (recently increased from $12,850) should be filed in the defendant's home-town federal district or bankruptcy court.

D. Preference Defenses

There are a number of defenses to a preference set forth in section 547(c) of the Bankruptcy Code (i.e. Ordinary Course of Business, New Value, and Contemporaneous Exchange).

III. Fraudulent Transfers

A. Section 548 of the Bankruptcy Code allows the trustee (or debtor-in-possession) to avoid a transaction made within two (2) years before the commencement of the bankruptcy case,

B. Section 544(b) of the Bankruptcy Code allows a trustee (or debtor in possession) to avoid a transfer under applicable non-bankruptcy law.

1. In Illinois, the Uniform Fraudulent Transfer Act (very similar to section 548 of the Bankruptcy Code) reaches back four (4) years.

2. In California, the Uniform Voidable Transactions Act also reaches back four (4) years, but for transfers made with the intent to hinder, delay or defraud creditors, can be tolled for one (1) year of when the transfer or conveyance was or could reasonably have been discovered by the creditor.

C. These statutes recognize as fraudulent those transfers made with actual intent to hinder, delay or defraud creditors, as well as those that are deemed to be constructively fraudulent, because they are made for less than reasonably equivalent value, when the debtor is, or is rendered, insolvent, undercapitalized, or unable to pay debts as they become due.

1. **Actual Fraud.** Circumstances from which courts have been willing to infer fraud include:

a. concealment of facts and false pretenses by the transferor;

b. transfers to spouses, related parties or other persons with a special relationship with the debtor;

c. transfers made in anticipation of actual or threatened litigation;

d. reservation by the transferor of rights (or control) in the transferred property;

e. his or her absconding with or secreting the proceeds of the transfer immediately after their receipt;

f. a transfer for no consideration when the transferor and the transferee know of the claims of creditors and know the creditors cannot be paid;

g. the existence of an unconscionable discrepancy between the value of property transferred and the consideration received therefore;

h. the fact that the transfer was made to satisfy or secure a debt long since forgiven;

i. the fact that the transferee was an officer or an agent or creditor of an officer of an insolvent corporate transferor; and

j. and the creation by an oppressed debtor of a closely-held corporation to receive the transferred property.

2. **Constructive Fraud** (whether or not intentionally made to defraud creditors) **-** transfers made for less than reasonably equivalent value, when the debtor is, or is rendered, insolvent, undercapitalized, or unable to pay its debts as they become due.

    a. Insolvent. The definition of insolvency is generally a balance sheet test in which the sum of the debts is greater than the sum of the assets, at a fair valuation, exclusive of property transferred with actual fraudulent intent, and property that may be exempted from the bankruptcy estate. You can also show that the debtor was not balance sheet insolvent, but simply unable to pay its debts as they became due.

    b. Reasonably equivalent value. Whether the transfer is for ``reasonably equivalent value'' in every case is largely a question of fact, as to which considerable latitude must be allowed to the trier of the facts. In order to determine if a fair economic exchange has occurred in a case of a suspected fraudulent transfer, the bankruptcy court must analyze all the circumstances surrounding the transfer in question. However, the Supreme Court in BFP v. Resolution Trust Corp. held that the consideration received from a noncollusive real estate mortgage foreclosure sale conducted in compliance with applicable state law "conclusively satisfies" the requirement that an insolvent debtor's property transfer, in the year prior to bankruptcy, be in exchange for a ``reasonably equivalent value.''

D. **Recovery and Standing**

1. Recovery – Generally, if the court determines that the transfer is recoverable as a fraudulent transfer, the trustee can recover the actual property transferred or will be provided a judgment in the amount of the value of the property transferred.

2. Standing – Generally, the Trustee (or debtor-in possession) has the exclusive standing to bring an action to recover a fraudulent transfer.

    a. Some courts will allow a creditors committee to bring the action on behalf of the estate;

b. If a DIP refuses, a creditor can file a motion to compel the debtor to bring the action (which ultimately may lead to the appointment of a trustee).

IV. Discharge/Dischargeability

A. Non-dischargeability of a particular debt and the denial of a debtor's general discharge are two distinct actions that may be brought by a creditor against a debtor in a bankruptcy proceeding.

   1. Certain types of debts are generally not allowed to be discharged by the debtor under the Bankruptcy Code.

   2. Under certain circumstances, there may be grounds to deny the debtor's discharge completely.

B. **Non-dischargeable debts –**a creditor may claim that the debtor performed certain bad acts toward the creditor while incurring the debt and that such act or acts should cause the particular debt to be excluded from the debtor's discharge. There are also certain types of debts that may not involve bad acts (e.g., certain taxes and student loans) that are non-dischargeable under the provisions of the Bankruptcy Code for public policy reasons.

   1. Certain debts are determined to be non-dischargeable under the Bankruptcy Code and require no action on the part of the creditor, while others require the creditor to file an action (an Adversary Proceeding) within the debtor's bankruptcy case for the court to determine.

      a. A prepetition settlement agreement (even one blessed by state court order) that a certain debt or judgment will be non-dischargeable in a future bankruptcy is unenforceable in a bankruptcy case against a debtor. Such an agreement is void as against public policy.

   2. Debts that are automatically deemed non-dischargeable under Section §523 (without the necessity of a creditor bringing a non-dischargeability action).

      a. Student Loans - Any "educational loan" that is either made, insured, or guaranteed by a governmental unit or made under a program funded in whole or in part by a governmental unit or nonprofit institution or that is a qualified education loan as defined in section 221(d)(1) of the Internal Revenue Code of 1986 is nondischargeable. (§523(a)(8)(A) and (B)). Any educational benefit loan made, insured, or guaranteed by a governmental unit or made under a program funded in whole or in part by a governmental unit or nonprofit institution is nondischargeable. (§523(a)(8)).

         A. There is an exception when repayment of the loan will impose an "undue hardship" on the debtor and the debtor's dependents.

b. Domestic Support Obligations - All domestic support obligations are non-dischargeable. (§523(a)(5)).

A. "Domestic support obligation" is defined in Section 101(14A) of the Bankruptcy Code and includes alimony, maintenance and support (among other things).

c. Unscheduled Debts - Not all unscheduled debts are automatically non-dischargeable. The following requirements must be met before a debt falls into this category:

A. The name of the creditor must be known to the debtor, and the debtor must have failed to schedule the creditor.

B. The creditor must not have any actual knowledge of the bankruptcy.

C. The creditor must have been harmed either because it could not file a timely complaint to determine dischargeability (for sections that require a complaint) or because the creditor did not have sufficient time to file a timely proof of claim (in a case in which there were assets to distribute to creditors).

d. Restitution – *§523(a)(7),* basically any fine, penalty, or forfeiture payable to and for the benefit of a governmental unit. (protects the government, not the creditor); or §523(a)(13) for a payment of an order of restitution issued under Title 18 of the United States Code. No matter to whom this is payable or for what purpose.

e. Certain Taxes are Non-dischargeable

A. 523(a)(7) Income taxes: 523(a)(7) excepts from discharge any income tax that is:

1. Income tax entitled to priority under Sec 507(a)(8)

a) Priority Status - Sec 507(a)(8) of the Bankruptcy Code provides priority status to income tax claims that:

i. 3-Year Rule – for taxes for which a return was last due within three years of the filing of the bankruptcy case;

ii. 240-Day Rule – assessed within 240 days of the filing of the bankruptcy case;

iii. Assessability Rule – the taxes are still assessable after the filing of the bankruptcy case; or

b) 2-Year Rule - Income tax for which no return was filed or a return was filed within two years of filing the bankruptcy case; or

c) with respect to a fraudulent return or willful attempt to evade tax.

B. §§523(a)(1) Generally, trust fund taxes (e.g., sales, employee withholding, collections by lottery agents).

f. The Bankruptcy Code also excepts a debt incurred for death or personal injury because the debtor was driving while under the influence. (§523(a)(9).

3. **Non-dischargeable debts requiring an Adversary to be filed**. Certain debts are only non-dischargeable if a creditor brings a timely action for a finding that the debt is non-dischargeable. (§523(c)(1)).

a. Timely: Chapter 7, 11 or 13 case, a complaint requesting a finding of non-dischargeability must be filed within 60 days after the date **first set** for the meeting of creditors (regardless of whether the meeting was continued on this date) or within any extension of time granted by court order (if the extension is requested before the expiration of the 60-day period).

b. **For Money, Property, or Services or an Extension or Renewal of Credit Obtained by False Pretenses, a False Representation, or Actual Fraud** (§523(a)(2)(A)).

A. If such claim arises from a consumer debt, a creditor gets the benefit of the presumption that debts of a certain type are non-dischargeable.

1. A consumer debt owed to a single creditor, aggregating more than $500.00 for luxury goods or services, incurred within the 90 days prior to the filing of the bankruptcy, is presumed to be non-dischargeable. (§523(a)(2)(C)(i)(n)).

2. Cash advances aggregating more than $750.00 made within the 70 days before the filing of the bankruptcy are presumed non-dischargeable. (§ 523 (a)(2)(C)(i)(n))

c. **Fraud or Defalcation in a Fiduciary Capacity, Embezzlement, or Larceny -** §523(a)(4) excepts a debt from discharge if it is a result of "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny".

d. **Willful and Malicious Injury to Another or Another's Property** - §523(a)(6) excepts debts for willful and malicious injury by the debtor to another entity or to the property of another entity.

A. The creditor must prove: (1) the debtor caused the injury, (2) the debtor's actions were willful, and (3) the debtor's actions were malicious.

C. Denial of the general discharge:

1. When the debtor has committed some bad act during the course of the bankruptcy proceeding or failed to list or schedule property of the bankruptcy estate, the creditor may file an adversary proceeding (must) seeking to have the debtor denied a discharge from all debts. (§727(c)).

2. These acts include:

   a. transferring or concealing property from the trustee,

   b. failing to keep records of financial transactions and of property,

   c. making a false oath within the bankruptcy, and

   d. failing to explain a loss of assets.

D. **Chapter 13 exceptions**: if a chapter 13 debtor completes all payments under the confirmed chapter 13, plan, the debtor will receive a slightly more inclusive discharge than a debtor under chapter 7.

1. Chapter 13 discharge will discharge the debtor from all debts except for:

   a. any claim where the plan proposes to finish paying the claim after the conclusion of the bankruptcy (such as priority claims or secured claims),

   b. certain tax obligations,

   c. for money or property obtained by false pretenses, a false representation, or actual fraud,

   d. for money or property obtained by use of a materially false statement in writing regarding the debtor's financial condition,

e. debts not listed or scheduled,

f. debts due to fraud or defalcation while acting in a fiduciary capacity,

g. domestic support obligations, student loans (except in cases of undue hardship),

h. for death or personal injury caused by operation of a motor vehicle, vessel or aircraft if caused while the debtor was intoxicated, and

i. damages awarded because of debtor's willful and malicious conduct if the conduct caused a personal injury or death.

V. Executory Contracts and leases

1. Executory Contracts and Residential Leases. A Chapter 11 debtor may assume or reject an executory contract or unexpired lease of residential real property or of personal property at any time prior to confirmation of a plan of reorganization. A Chapter 7 trustee generally has 60 days to assume or reject any contract or lease of residential property;

    a. However, on request of a party to such contract or lease, the Court may set a specific time to assume or reject prior thereto. Section 365(d)(2) of the Bankruptcy Code.

    b. If the debtor assumes the contract, it will be required to cure defaults and provide adequate assurance of future performance.

    c. Anti-assignment and bankruptcy default provisions (i.e., "ipso facto clauses") in executory contracts and unexpired leases are generally not enforceable in bankruptcy.

    d. Upon rejection, the contract is deemed terminated as of the filing of the case and all termination damages become pre-petition claims (i.e. generally unsecured claims).

2. Non-Residential Leases. The Chapter 11 debtor must assume or reject any unexpired lease of non-residential real property within one hundred twenty (120) days after the entry of the order for relief.

    a. That period, however, may be extended on a timely motion showing good cause for an extension (but no longer than 90 additional days).

    b. If there is no assumption or extension of time within which to assume within said 120 day period, the lease is deemed rejected as a matter of law and the debtor must surrender said premises to the lessor, even though there may have been no default under the lease and it may have years to run. Section 365(d)(4) of the Bankruptcy Code.

    c. If the debtor assumes the lease, however, the debtor will still be liable for the rent reserved by the lease regardless of whether or not the debtor uses or occupies the premises, and regardless of its value.

    d. Even if the debtor rejects the lease, the debtor will still be liable for the rent reserved up to the time of rejection.

VI. Bankruptcy Provisions in Subordination Agreements

1. Subordination Survive a Bankruptcy Filing. The senior loan shall remain senior in the event of a Bankruptcy Proceeding and the subordination shall be enforceable. Shows knowledge and intent of the senior and junior lender.

    a. Section 510(a) of the Bankruptcy Code. Maintains the enforceability of subordination agreements in bankruptcy cases to the same extent as they are enforceable under applicable nonbankruptcy law;

2. Payment and Liens. Senior loan remains preferred in payment over junior loan and senior liens remain senior over junior liens.

3. Senior must be paid in full. Senior loan must be paid in full before any payment is made upon the junior loan.

4. Deep Subordination Provision. In the event of any payment or distribution of any kind or character, whether in cash, property or securities (i.e. equity as a part of a reorganization) to the junior lender it shall be paid over to the senior lender until the senior loan is paid in full. This is probably the most critical provision in favor of a senior lender.

5. Proof of Claims. Junior lender, as the holder of the junior loan, undertakes and agrees for the benefit of senior lenders to execute, verify, deliver and file any proofs of claim, consents, assignments or other instruments which senior lenders may at any time reasonably require in connection with any Bankruptcy Proceeding. Senior lender wants the junior lender to file a claim, since it creates a greater potential of recovery from debtor's estate (if junior lender must pay recovery to senior lender first).

6. Junior Lender Cooperates with Senior Lender. Junior lender will not oppose senior lenders motion for relief from the stay to foreclose or other proceedings (i.e. valuation, etc.).

    a. Bankruptcy Plan Voting:

        i. Chapter 11 Plan Voting Basics:

        ii. Classes. Claims are put into different classes and the classes vote to accept or reject the Plan;

iii. Acceptance. A class is deemed to have accepted the Plan if the holders of claims equaling at least two thirds (2/3) in amount and more than one half (1/2) in number (of the those claims that actually voted in said class) vote to accept the Plan. Note that include insider claim votes do not count toward the acceptance of a plan.

iv. Cram Down. The Bankruptcy Code also allows for confirmation of the Plan in the absence of all Class acceptances.

   i. Under appropriate circumstances, a Plan that is not accepted by all classes of impaired creditors and interest holders may still be confirmed by the court.

   ii. If there is at least one impaired Class and the plan is deemed fair and equitable.

b. Senior Votes Junior Claim: Often subordination agreements provide that the Senior Lender can vote Junior Lender's claim (i.e. may be a vote for a plan the senior lender supports or against a plan the senior lender opposes); or

   i. Approved Plan. Some subordination agreements provide instead that junior lender agrees to only support plan approved by senior lender and that junior lender shall not propose any plan or vote to confirm or take any other action in support of any plan or other course of action proposed by any other party (other than senior lenders) which would have the effect of (A) impairing the priority or lien of the senior loan, (B) denying, impeding or delaying senior lenders' efforts to collect the senior loan, or (C) delaying, preventing, limiting, requiring a reduction in the amount of or impairing senior lenders' collection of all or any portion of the senior loan.

   ii. Transferring Plan Voting Rights. Enforceability of transferring plan voting rights to senior lender is approximately 50/50 in the BK Courts right now. Some courts have held that the subordination agreement should control. Others have held that voting on a plan is a statutory right that cannot be conveyed.

   iii. Agency. Some courts suggest you need to be appointment as "agent" for voting purposes and that may give you the right to vote another creditors claims, but that might also impose a fiduciary duty and potential liability that cannot be waived.

2. Doctrine of Prudential Standing; - an additional exception to allowing a junior lender to vote; If so deeply subordinated it is clear that the junior lender will have no financial benefit in the outcome of the BK case, they have no standing in the case and their vote will not be counted. So, if this doctrine applies, the senior lender cannot use the junior lender's claim to reject (or accept a plan), but at least their vote cannot be used to hurt the senior lender's position.

Fox Rothschild LLP
ATTORNEYS AT LAW

Presenters

Michael A. Sweet | **Partner and Chair, Financial Restructuring and Bankruptcy Department**
T: 415.364.5560
msweet@foxrothschild.com

Michael represents debtors, creditors, creditors' committees and trustees in bankruptcy disputes nationally. He takes a creative approach to dispute resolution with the goal of maximizing recovery for clients inside and outside the courtroom. Michael has extensive experience litigating preferences, fraudulent conveyances, claims objections and plan confirmation, and he frequently advises clients in financial distress on bankruptcy avoidance. He has secured multimillion-dollar recoveries for clients in preferential transfer and avoidance action proceedings. Michael is an appointed Resolution Advocate on the Bankruptcy Dispute Resolution Panel for the U.S. Bankruptcy Court for the Northern District of California.

Brian R. Anderson | **Partner**
T: 336.378.5205
branderson@foxrothschild.com

Brian concentrates his practice on bankruptcy, creditors' rights and commercial litigation. He regularly represents banking and financial institutions, credit unions, businesses, contractors, secured and unsecured creditors, trustees, executors and guarantors before state and federal courts. Brian also provides strategic counsel on a wide range of bankruptcy issues, including complex Chapter 11 cases, avoidance actions, adversary proceedings and out-of-court workouts.

Deana A. Labriola | **Partner**
T: 919.719.1251
dlabriola@foxrothschild.com

Deana is an experienced corporate transactional attorney who centers her practice on mergers, acquisitions and debt and equity financing deals. She routinely serves as lead counsel to sellers and buyers in connection with the sale of operating companies to or on behalf of strategic purchasers, private equity investors and management/owner teams. She also assists businesses with corporate governance structuring, development initiatives and expansion opportunities.