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207 - Bankruptcy 101

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Session 207

Faculty Biographies

Richard Ferrell

Richard Ferrell is a senior counsel in the Work-Out Group of Wells Fargo Bank's legal department. He is involved in troubled debt restructurings, UCC Article 9 dispositions, and other creditors' rights and remedies as well as Chapter 11 and 7 commercial bankruptcy matters for real estate, equipment finance, and other troubled loans.

Prior to joining Wells Fargo, Mr. Ferrell was an outside counsel with the firms of Taft Stettinius & Hollister LLP and Arter & Hadden, LLP, practicing in corporate restructuring, bankruptcy, and creditors' rights.

Ann Nolan

Ann Nolan is an associate general counsel for IDEXX Laboratories, Inc., a publicly traded international company located in Westbrook, ME that focuses on diagnostic products and services for veterinary, production animal and water applications. Her responsibilities include providing legal counsel to multiple lines of business on a wide variety of corporate matters, supporting the corporate finance function and managing company wide privacy initiatives.

Prior to joining IDEXX, Ms. Nolan clerked for the Honorable Eugene E. Siler, Jr. of the United States Court of Appeals for the Sixth Circuit, and practiced law with the firms of Davis Polk & Wardwell in New York, NY and Sheehan Phinney Bass + Green in Manchester, NH.

Ms. Nolan received a BS from Cornell University and is a graduate of the University of Kentucky College of Law.

Deborah J. Saltzman

Deborah Saltzman is a judge of the United States Bankruptcy Court for Central District of California.

Prior to her appointment to the bench, Judge Saltzman practiced bankruptcy law, most recently with the law firm of DLA Piper in Los Angeles. While in practice, she represented debtors, secured and unsecured creditors, asset purchasers, creditors' committees, and landlords in chapter 11 and out-of-court restructurings as well as related financing transactions and litigation.

Judge Saltzman regularly teaches continuing education programs and speaks on issues related to bankruptcy and restructuring. She is a member of the National Conference of Bankruptcy Judges, the American Bankruptcy Institute, the Financial Lawyers

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Conference, the Los Angeles Bankruptcy Forum, and the Inland Empire Bankruptcy Forum.

A native of Buffalo, New York, Judge Saltzman received her BA in history from Amherst College and her JD from the University of Virginia School of Law.

John A. Thomson, Jr.

John Thomson is a member of Womble Carlyle Sandridge & Rice, PLLC, resident in its Atlanta office. Mr. Thomson is a member of Womble Carlyle's Bankruptcy and Creditors Rights practice group, where he focuses on the representation of financial institutions, commercial trade creditors, life insurance companies, and private equity investors in bankruptcy, pre-bankruptcy restructuring transactions and commercial litigation.

Mr. Thomson has represented financial institutions in all facets of commercial bankruptcies, including cash collateral issues, stay related proceedings, debtor-in-possession financing, sales of assets from the bankruptcy estate, contested confirmation issues, and adversary proceedings arising out of avoidance claims. In addition to his creditor representation, Mr. Thomson was debtor's counsel in the Chapter 11 reorganizations of Peachtree Natural Gas, LLC, American Plastic Surgery, LLC, and Gulf Coast Restaurants Inc.

Currently Mr. Thomson is a member of the board of directors of the Southeastern Bankruptcy Law Institute, and the treasurer of the Bankruptcy Section of the Atlanta Bar. He has been chosen as a member of the Georgia Trend Legal Elite and the Atlanta Magazine Georgia Super Lawyers.

Mr. Thomson received his AB from Davidson College and his JD from the University of Georgia.

Tracy Treger

Tracy L. Treger is the vice president and assistant general counsel of Ridge Property Trust, a privately held real estate investment trust specializing in state of the art warehouse, distribution and manufacturing facilities throughout the United States and Mexico. Ms. Treger is responsible for the implementation and management of all legal matters relating to Ridge's ongoing day-to-day acquisition, development, construction, leasing, financing and ownership activities, as well as all corporate legal matters relating to the operation of Ridge and its joint venture relationships in the US and Mexico.

Prior to joining Ridge, Ms. Treger was a partner in a large national law firm where she represented creditors' committees, lenders, bondholders, real estate and equipment lessors, trustees, and debtors in Chapter 11 cases ranging from single-asset real estate matters to mega-bankruptcies (i.e., Mirant Corp., United Airlines, Kmart), as well as state court and out-of-court corporate restructurings. She has also published several articles on a variety of legal topics.

In addition to ACC, Ms. Treger is a member of the Chicago Bar Association. She serves on the National Legal Affairs Committee of the Anti-Defamation League, advising on the filing of amicus briefs in civil rights cases.

Ms. Treger received a BA and MS from the University of Pennsylvania and her JD from the Chicago-Kent College of Law.

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BANKRUPTCY 101: CORPORATE COUNSEL'S TOOLBOX

Association of Corporate Counsel
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John A. Thomson, Jr.
Womble Carlyle Sandridge & Rice, PLLC
Atlanta, Georgia

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The bankruptcy system in America, which is operated pursuant to the United States Bankruptcy Code (11 U.S.C. § 101 *et seq*.), is designed to provide a defined and equitable system under which individuals and corporations can either restructure their debts or liquidate their assets and distribute the proceeds of those assets to the creditors of the bankrupt entity.

I. ALTERNATIVES TO THE FILING OF A CONTESTED BANKRUPTCY CASE

While bankruptcy is a very defined and orderly process for reorganizing debts and liquidating assets, the bankruptcy process can be time consuming and expensive. Before a Debtor elects to unilaterally file a contested bankruptcy case, there are certain alternatives that may provide comparable treatment to the Debtor and its creditors without the time and expense associated with a bankruptcy case. In particular:

A. **Consensual Workout** – A Debtor and its creditors may enter into negotiations whereby the Debtor enters into modified loan documents that will control the Debtor's future operations and the manner in which it manages its business. These modified loan documents can include provisions that (i) provide extra collateral to the Debtor's secured lenders, (ii) govern the Debtor's use of its operating cash flow, (iii) restrict the Debtor's ability to distribute dividends or other payments to shareholders and insiders, and other provisions specifically designed to enhance the lender's security and protect the lender's collateral within a structure that the Debtor can accept. Workouts can be complex structured transactions, and the lender and its counsel must be vigilant that the loan documents are properly executed and recorded such that the lender preserves its priority claim with regard to the Debtor's collateral property.

B. **Appointment of a Receiver** – In situations where the Debtor is not performing under its loan obligations, or is not adequately protecting the secured creditors' collateral, a

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creditor can move for the appointment of a receiver. While the Federal Rules of Civil Procedure provide for the appointment of a receiver, Federal Rule of Civil Procedure 66 provides that receiverships are generally state court proceedings. Under the applicable provisions of state law, a state court judge with jurisdiction over the Debtor will appoint an individual or entity to act as receiver to step into the shoes of the Debtor corporation's management and manage the Debtor's assets and operations. The receiver serves at the pleasure of the judge that appointed him, and has the powers specified by the judge in the order appointing the receiver. Receivership codes differ from state to state, and the powers that can be conveyed to a receiver vary according to the differences in these codes.

The recent economic collapse has given rise to a large upswing in the number of receivership actions. State courts, as well as certain state legislatures, are increasingly willing to vest receivers with extraordinary powers to manage the Debtor's operations, liquidate the Debtor's assets, negotiate with the Debtor's creditors, reject the Debtor's executory contracts and otherwise administer the Debtor's affairs. A receivership is very often a contentions proceeding that takes place only after the relationship between the Debtor and its creditors has been irreparably damaged.

C. **Assignments for the Benefit of Creditors** – A Debtor can voluntarily elect to cease its operations and liquidate its assets by filing a state court proceeding known as an assignment for the benefit of the creditors. In an assignment for the benefit of creditors, the Debtor designates an assignee, which is typically an individual that operates in a manner similar to a trustee in bankruptcy. The assignee takes control of the Debtor's assets, liquidates the Debtor's remaining assets, reviews the claims that

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have been asserted against the Debtor, and distributes the assets in accordance with the priority set up by that state's Commercial Code. Some states have well defined statutes governing assignments for the benefit of creditors, and the state court judges in those states are generally familiar with the procedures by which an assignee will wind down the operations of the company, liquidate its assets and pay its claims. Other states, however, have very poorly defined statutes governing assignments of the benefit of creditors, and the state court judges in these jurisdictions may not be familiar with the requirements or protocol for liquidating a company and distributing its assets. As a consequence, both Debtors and creditors have to take care before they elect to rely upon an assignment for the benefit of creditors.

D. **Pre-Packaged Bankruptcies** – Pre-packaged bankruptcies are centered around consensual agreement whereby the Debtor and a significant group of its secured and unsecured creditors reach an agreement, prior to the filing of the petition, as to how the Debtor will be operated and how the Debtor will manage its assets post-petition. Pre-packaged bankruptcies can be very difficult to structure, as they often require cooperation between many of the Debtor's constituent creditors that may have competing interests. If the Debtor can reach a consensual agreement with its creditors, however, the Debtor will then file a plan that incorporates the agreed-upon provisions and move quickly and aggressively confirm to that plan. While it is not always the case, pre-packaged bankruptcies often involve either a sale of the Debtor's assets to a strategic buyer or a change in the Debtor's operating management.

II. BASIC CHAPTER OPTIONS

There are three basic options for individuals and corporations that seek bankruptcy protection (hereinafter the "Debtor"). They are as follows:

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a) **Chapter 7** – Chapter 7 can be used for the liquidation of the assets of an individual or a business. In a Chapter 7 case, a trustee is appointed to administer the Debtor's assets, liquidate those assets as appropriate, review the claims that have been asserted against the bankrupt entity and distribute those assets according to the priorities set forth in the Bankruptcy Code.

b) **Chapter 13** – Chapter 13 is a vehicle for individuals with liquidated, non-contingent secured debt of less than $1,010,650 and liquidated, non-contingent general unsecured debt of $336,900 to reorganize their debts. Chapter 13 is generally designed for wage earners who have a regular income and a relatively small number of creditors. A Chapter 13 Debtor often files the case to save his or her personal residence from foreclosure and either to restructure or to eliminate some of his or her general unsecured debts such as credit card obligations.

c) **Chapter 11** – Chapter 11 is a bankruptcy proceeding wherein corporations or individuals with large amounts of debt can either (i) reorganize and restructure their debt, or (ii) liquidate their assets in an orderly fashion and distribute the proceeds to their creditors. Chapter 11 is typically the most complex of the bankruptcy sections, and presents the most diverse range of options regarding to how the Debtor will manage its assets and reorganize its debt obligations. In a Chapter 11 action, the Debtor's existing management typically remains in control of the company's operations and the Debtor operates as "Debtor-In-Possession." Chapter 11 Debtors are not generally controlled by a trustee unless and until the court deems it appropriate to appoint a trustee to manage the company's affairs.

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III. THE BANKRUPTCY COURT SYSTEM

The bankruptcy system is generally administered by bankruptcy courts that operate in every federal judicial district in the United States. Unlike federal district courts, the Bankruptcy Courts are not Article III courts. Instead, they operate as an adjunct to the federal district court in each district. 28 U.S.C. § 151. As a general proposition, cases that seek relief under the Bankruptcy Code are automatically assigned to the Bankruptcy Court for the federal judicial district in which venue lies by virtue of a standing order from the District Court, often referred to as "the reference." 28 U.S.C. § 157(a). See, e.g.,

The Bankruptcy Courts are administered by United States bankruptcy judges, who are appointed by the Court of Appeals for the federal judicial district in which they sit. 28 U.S.C. § 152. Bankruptcy judges are appointed for fourteen-year terms, which can be renewed upon approval by the appropriate Circuit Court. Id.

IV. JURISDICTION

As noted above, the Bankruptcy Courts generally have jurisdiction, through the reference, over any bankruptcy cases that are filed within their federal judicial district. Bankruptcy often gives rise to a number of litigation proceedings under certain sections of the Bankruptcy Code. In addition, the Debtor will often have causes of action for events that have occurred prior to the filing of the petition that need to be adjudicated. These actions are referred to as either contested matters, which are governed by Bankruptcy Rule 9014, or Adversary Proceedings, which are defined by Bankruptcy Rule 7001.

The United States Judicial Code, 28 U.S.C. § 157(b)(2)(A)-(B), defines certain specific types of actions involving the Debtor, particularly actions that arise under the Bankruptcy Code post-petition, as "core" proceedings. Bankruptcy judges may hear and make rulings upon any core proceedings. 28 U.S.C. § 157(b)(1).

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Other actions that do not involve specific bankruptcy-related causes of action, or are otherwise governed by state law statutes and common law, can either be (i) heard by the Bankruptcy Court, which will provide proposed findings of fact and conclusions of law to the district court for entry of a final order; (ii) the Federal District Court, through withdrawal of "the reference," or (iii) the appropriate state courts if the Bankruptcy Court decides to abstain pursuant to 28 U.S.C. § 1334(c)(2).

V. HOW THE BANKRUPTCY CASE IS INITIATED

The Debtor initiates a bankruptcy case by filing a petition with the clerk of the Bankruptcy Court for any federal judicial district in which:

a) The Debtor maintained its principal place of business;

b) The Debtor maintained its domicile; or

c) The Debtor's principal assets have been located

for the previous one hundred eighty (180) days. 28 U.S.C. § 1408. This provides Debtor corporations, particularly a large corporation, with a significant number of options as to the district in which it will file its case. Many larger companies that are either Delaware corporations or New York corporations will choose to file in either the Southern District of New York or the District of Delaware, both of which have very well developed bankruptcy and restructuring bars. Other corporations will look at their operations, their business offices and the areas in which they have assets and file the case in the bankruptcy district in which they feel comfortable with the judges, the operating procedures of the court, and the court's accepted practices with regard to administration of the case and the payment of professional fees.

In addition to filing its petition, the Debtor must file the following documents:

a) A resolution from the Debtor corporation's Board of Directors, or managing member authorizing the filing of the petition;

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b) A list of the Debtor's top twenty largest unsecured creditors; and

c) A matrix, which is essentially a list of every one of the Debtor's creditors and the applicable address for each creditor.

The matrix is used to prepare a computerized mailing to each of the Debtor's creditors that informs the creditors of the filing of the case. The notice of filing will designate the district in which the case has been filed, the judge to whom the case has been assigned and the case number. ***The notice of filing, which is typically a one-page document, can be extraordinarily important because it often designates the date by which creditors must file their proofs of claim.*** Every corporate entity that has occasion to deal with other corporations in the ordinary course of its business should have its mail department trained to identify bankruptcy notices, particularly notices of filing, and pass them on to the office of counsel for appropriate attention.

VI. THE PLAYERS IN THE BANKRUPTCY PROCESS

Once a bankruptcy petition is filed, there a number of parties that will have an impact on the case, specifically:

A. **The Debtor –** The Debtor is the party that seeks bankruptcy relief through the petition. In a Chapter 11 proceeding, the Debtor generally operates as a Debtor-in-possession, during which it is in control of its own affairs until such time as the Court enters an order appointing an examiner or otherwise appointing a Trustee to manage the Debtor's affairs.

B. **Debtor's Counsel –** In most districts, a corporation cannot file a bankruptcy without a lawyer. In a Chapter 7 context, the role of the Debtor's counsel is limited to filing the case and preparing the Debtor's schedules and statement of financial affairs. After the case is filed, the appointed Chapter 7 trustee will retain its own counsel to assist in the administration of the estate. In a chapter 11 action, however, Debtor's

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counsel will continue to be active in the case, will assist the Debtor in its negotiations with its creditors post-petition, and will further assist the Debtor in filing and confirming a plan of reorganization.

C. **The United States Trustee** – In most states, there is an appointed United States Trustee that is an employee of the United States Department of Justice. This United States Trustee oversees all bankruptcy cases filed within that district. The United States Trustee will generally employ a number of attorney advisors who are active participants in chapter 7 cases and in chapter 11 cases. In essence, these Trustees serve to insure that the Debtor is meeting its obligations under the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure with regard to paying its post-petition debts as they come due, filing monthly operating reports and otherwise pursuing confirmation of a plan of reorganization.

D. **The Official Committee of Unsecured Creditors** – The Debtor's secured creditors often have significant control over the manner in which the Debtor uses its cash and operates its business both pre- and post-petition. General unsecured creditors, on the other hand, often have little control over the Debtor's operations, and cannot justify retaining an attorney to represent their individual interests in the bankruptcy case. In order to balance the inherent power of the secured creditors, and to provide a voice to the general unsecured creditors, the United States Trustee's Office will often form an Official Committee of Unsecured Creditors (the "Committee"). 11 U.S.C. § 1102. The Committee is typically charged with (i) consulting with the Debtor and the United States Trustee regarding the administration of the case; (ii) investigating the Debtor's financial affairs, including whether the Debtor should continue to operate; and (iii) consult with the Debtor and participate in the formulation of the Plan. The

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members of that Committee, which are often drawn from a cross-section of the Debtor's unsecured creditor body, have the ability to retain counsel and retain financial professionals to help represent the interests of the unsecured creditors during the course of the case. 11 U.S.C. § 1103(a). Counsel and other professionals retained by the Committee will be compensated either from a "carve out" from the proceeds of the secured creditors' collateral or from the Debtor's post-petition operating income. As soon as the Committee has been formed, it generally retains counsel, and counsel becomes heavily involved in negotiations over the cash collateral, DIP financing and the formulation and confirmation of the Debtor's plan.

A creditor may be called upon to serve as a member of the Committee. If a creditor chooses to serve on the Committee, the creditor will act as a fiduciary for all of the general unsecured creditors. As a consequence, a creditor that chooses to serve as a member of the Committee cannot take action that would solely benefit its own unsecured claim against the Debtor. Any creditor that agrees to serve as a member of the Committee must carefully weigh whether its operating relationship with the Debtor, and its financial relationship with the Debtor, is such that serving on the Committee may constitute an impermissible conflict of interest.

VII. THE AUTOMATIC STAY

One of the most important aspects of filing a bankruptcy case is the imposition of the automatic stay under 11 U.S.C. § 362(a). As a general proposition, a bankruptcy case automatically stays, among other things:

a) The commencement or continuation of any judicial, administrative or other proceeding against the Debtor, which generally includes further work on any pending lawsuits;

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b) Any act to collect or enforce a claim, which can include any written or telephonic collection efforts;

c) Any act to exercise control over, or obtain possession of, any of the Debtor's property, which generally includes all levies or executions on judgments;

d) Any act to enforce a lien against any of the Debtor's property;

e) Any act to effect a setoff any debt due from the Debtor to a creditor prior to the filing of the petition; or

f) Any act to perfect a lien against the Debtor's property for a debt that arose pre-petition.

11 U.S.C. § 362(a). This list is not exclusive, and there are a number of other acts that are specifically stayed by the imposition of the automatic stay. For each of these actions, the stay applies to actions by a creditor or its agents.

There are certain exceptions to the automatic stay, including:

a) The commencement or continuation of criminal proceedings against the Debtor;

b) The commencement or continuation of civil proceedings against the Debtor pertaining to divorce, paternity, domestic support or domestic violence;

c) Certain tax audits and tax assessments by government taxing authorities.

11 U.S.C. §362(b). There are also a myriad of specific actions that are not prohibited by the automatic stay.

The safest course of action for a creditor who learns that one of its customers or debtors has filed for bankruptcy is to cease all efforts to assert or collect the claim or debt until such time as bankruptcy counsel can determine whether the creditors activities are prohibited by the automatic stay. The penalties for willfully violating the automatic stay can be severe, and creditors are well advised to be safe rather than sorry in their post-petition contacts with parties against whom they have claims.

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VIII. FIRST DAY MOTIONS

When an operating company files for bankruptcy, it often must obtain immediate authority from the Bankruptcy Court to maintain certain facets of its operations. As a result, counsel for the Debtor will file certain "first day motions." These first day motions can include:

a) A motion to control the Debtor's relationship with its various utilities. *See* 11 U.S.C. § 366;

b) A motion to allow the Debtor to pay its employees wages that were earned pre-petition, but not paid as of the date of the filing, as these claims are administrative priority claims up to $10,950. 11 U.S.C. § 507(a)(4). Debtors often structure their filings to coincide with regular paydays in order to avoid, to the extent possible, this issue;

c) A motion to allow the Debtor to use its existing bank accounts, instead of having to open new "debtor-in-possession accounts," which are typically required by the United States Trustee's guidelines;

d) A motion to authorize the Debtor to employ its professionals. 11 U.S.C. § 327;

e) A general motion by the Debtor to continue certain contractual and vendor relationships that the Debtor designates to be critical to its continued operations (a discussion of what constitutes a "critical vendor" follows hereinbelow);

f) A motion to use "cash collateral," which are generally the proceeds from the sale of a lender's collateral or the rents received from the lender's collateral. 11 U.S.C. § 363(a);

g) A motion to approve Debtor-in-possession ("DIP") financing, which is the financing that the Debtor will use to operate post-petition. 11 U.S.C. § 364.

Some first day motions are largely perfunctory . . . it is generally in the best interests of the Debtor and the creditors for the Court to approve first day motions that allow the Debtor to pay its

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employees, maintain its accounts, retain utility service and operate efficiently. Other first day motions, such as motions for the use of cash collateral and motions to approve DIP financing, are so important, and may impact so many creditors, that they are often heard on an interim basis during the early days of the case. A hearing to consider final orders for the use of cash collateral and the terms of DIP financing will often be scheduled at a later junction in the case. ***If counsel for a creditor has knowledge that his client has a significant involvement in a bankruptcy, it is appropriate to make arrangements to, at a minimum, review the case docket and the first day motions that are being considered and determine whether any of the first day motions might significantly impact the interest of that creditor.***

IX. THE 341 FIRST MEETING OF CREDITORS

The Bankruptcy Code prescribes that within a reasonable time after the Petition Date the United States Trustee shall hold a meeting of creditors. 11 U.S.C. § 341. As a general rule, the trustee will conduct the 341 Meeting of creditors, and will question the Debtor regarding certain basic aspects of the Debtor's post-petition operations, including status of its insurance, debtor-in-possession bank accounts, outstanding sales and employment tax liabilities and other issues that impact the Debtor's post-petition operations. The Trustee will then open the floor of the 341 Meeting for questions by creditors and other constituent parties to the bankruptcy.

The 341 Meeting is recorded, and the testimony that the Debtor or the Debtor's representative provides is made under oath. As a consequence, some creditors will use the 341 Meeting as an opportunity to take "free" discovery regarding certain points that the creditor may wish to prove in connection with a motion for relief from stay or motion to dismiss the case. Most trustees will resist this type of discovery, however, and will instead urge the creditor to conduct an examination of the debtor pursuant to Fed. R. Bankr. P. 2004.

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The 341 can provide an opportunity to meet the Debtor, and the Debtor's principals, and take some measure of whether the Debtor will be able to successfully operate post-petition and confirm a Plan. Further, parties at the 341 Meeting may discuss certain aspects of the debtor's relationship with a creditor that may be untrue, misleading or incorrect, and thus detrimental to the creditor that is the topic of the discussion. As a consequence, it is generally prudent to send a representative to the 341 Meeting in order to have precise record of what was discussed.

If certain creditors of the debtor are not satisfied with the individual that has been appointed as a trustee in any given case, that creditor may move to elect a new trustee at the 341 Meeting. Fed. R. Bankr. P. 2003(B)(3). Creditors are only entitled to vote for the election of a trustee if they have filed a proof of claim prior to the 341 Meeting. Votes are tabulated based on the aggregate amount of the claims that cast votes for the new trustee. If the election is disputed, the court may hold a hearing to determine whether it is appropriate to appoint the elected trustee as the permanent trustee. Elections of trustees can be valuable in situations where the interim trustee does not have the requisite skill or resources to properly liquidate the Debtor's property.

X. POST-PETITION OPERATIONS

After the consideration of first day motions and the entry of certain first day orders, the Debtor, as a general rule, begins operating in Chapter 11 as debtor-in-possession. The Debtor's post-petition operations are guided by (i) the Bankruptcy Code, (ii) the Federal Rules of Bankruptcy Procedure; (iii) the first day orders; (iv) the United States Trustee's Operating Guidelines; and (v) the provisions of its pre-petition loan agreements with its creditors. Certain basic rules apply to the Debtor's operations post-petition:

A. **No Payments to Creditors on Behalf of Pre-Petition Debts** – Subsequent to the filing of the petition, the Debtor cannot make payments to its vendors or creditors on account of debts incurred prior to the filing of the petition. The Debtor may, and

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generally will, continue to deal with its operating vendors and service providers after the petition is filed, but the Debtor can only pay those providers for goods and services provided post-petition. This often places a significant burden on the Debtor, as it no longer has access to unsecured trade debt. Trade vendors will typically demand that the Debtor pay cash or immediately available wire funds for goods and services, and the Debtor, which has been accustomed to operating on thirty or sixty days business credit terms, will not have sufficient cash resources to buy the inventory and raw materials post-petition.

B. **Sequestration and Use of a Lender's Cash Collateral** – The Debtor's pre-petition lenders will generally have a security interest in the Debtor's assets, whether they be inventory, furnished goods, accounts receivable, or real property, as well as the profits or proceeds from the sale or use of this collateral. Lenders that have a security interest in the Debtor's income-producing property will have a lien on the rents and profits flowing from the property. Lenders that have a lien on the Debtor's inventory, work in progress or accounts receivable will also have a lien on the Debtor's accounts receivable from the sale of the Debtor's inventory, and the cash proceeds from the collection of the accounts receivable. At the onset of the case, the pre-petition lender will typically send a letter to the Debtor sequestering cash collateral, and demanding that the Debtor not use the proceeds from the lender's collateral in the operation of the Debtor's business. The Debtor will thereafter be unable to use the proceeds from the liquidation of accounts receivable, the rents from real property or proceeds from the sale of inventory until an order has been entered allowing the Debtor to use this "cash collateral," 11 U.S.C. § 363(c)(2). The cash collateral order will govern the circumstances under which the Debtor can use the cash collateral in business

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operations. The cash collateral order generally contains a very detailed budget under which the Debtor will operate its business. Further, the cash collateral order will provide the secured creditor with post-petition replacement lien in the Debtor's accounts receivable, inventory or rents generated post-petition. Cash collateral orders are generally intensely negotiated between the various parties in the case. Parties other than the secured lenders carefully monitor these negotiations, and the terms of the cash collateral order to ensure that the secured creditor does not improperly enhance its collateral position or otherwise insist upon terms in a cash collateral order that will unnecessarily weaken the Debtor's cash position.

C. **Motions to Approve Debtor-In-Possession Financing** – Most larger corporations operate with capital from some type of revolving or asset-based credit facility from a financial institution. Once the bankruptcy case is filed, the secured lender will often refuse to provide further credit under the existing pre-petition facility. As a consequence, the Debtor must often secure debtor-in-possession financing or "DIP financing" in order to sustain its post-petition operations. DIP financing is provided to the Debtor under the general provisions of 11 U.S.C. § 364. DIP financing can be provided by either the existing secured lender, or a lender that specializes in providing DIP financing. As one can imagine, DIP financing arrangements typically provide for very tight control over the Debtor's use of the collateral property, tight restrictions over the circumstances under which the Debtor can receive and expend cash, and interest rates that are significantly higher than market rates for healthy companies. In addition, many DIP financing arrangements include the payment of substantial up-front origination and underwriting fees. The terms of DIP financing agreements, as well as the collateral that secures the DIP financing facility, are

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typically subject to tight review and restriction by the Court and the other constituent parties in the case. While there is often an effort to ensure that DIP financing arrangements do not impair the Debtor's ability to operate or provide undue fees to the DIP lender, the reality is that there are often few, if any, alternative sources to DIP financing, and the entities that provide DIP financing have significant leverage over the terms under which they will lend to the Debtor.

XI. POST-PETITION REPORTING

The bankruptcy system is designed to provide transparency regarding the Debtor's post-petition operations and financial affairs. As a consequence, the Debtor is under an obligation to make periodic reports and filings regarding its operations and its financial circumstances. *See*, *e.g.*, 11 U.S.C. §§ 1106 and 521. At a minimum, the Debtor will be required to file monthly operating reports with the clerk of the Bankruptcy Court. These reports, which are prepared in accordance with forms provided by the Office of the United States Trustee, require the Debtor to (i) detail its sources and uses of funds, provide information regarding the activity in its bank accounts; and (ii) provide other information regarding the Debtor's payment of certain mandatory obligations like payroll taxes, sales taxes and payments to employee benefit plans.

In addition to monthly operating reports, the Debtor may be under more stringent requirements from its pre-petition secured lender pursuant to the terms of the cash collateral order, or its DIP lender in accordance with the terms of the order approving the DIP financing order. In either instance, the Debtor will likely be required to submit detailed reports of its financial operations to the lender, with copies to the other significant constituent parties in the case.

The financial operating reports are a necessary and vital part of the bankruptcy system. As a consequence, a Debtor must maintain (i) adequate financial reporting procedures, books and records; (ii) an accounting staff that is adequate in size and skill for the scope of the Debtor's operations; and

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(iii) the ability to generate financial reporting information. If the Debtor does not file adequate timely reports, the United States Trustee will likely move to have the case dismissed. Further, if the Debtor cannot meet its reporting obligations with regard to the Debtor's existing financing, the secured lender may similarly move to either terminate the Debtor's use of cash collateral or have the case dismissed or converted.

The monthly operating reports can be a great source of information for all types of creditors. By reviewing the monthly operating reports, the constituent creditors can ascertain whether the Debtor is building or liquidating inventory, building or bleeding its accounts receivable, paying its mandatory taxes as and when due, and generally operating in a profitable fashion post-petition.

XII. VENDOR RELATIONSHIPS AND CLAIMS FOR GOODS DELIVERED

In many corporate Chapter 11 cases, the largest constituency will be creditors that have provided goods or services to the Debtor on credit. As of the Petition Date, these creditors will often have significant claims for accounts receivable arising out of goods and services that were delivered prior to the Petition Date for which that creditor has not been paid. As a general rule, these accounts receivable are general unsecured claims, and they are rarely paid in full. There are two notable exceptions, however, that may allow general unsecured trade vendors to receive a more substantial recovery on their pre-petition accounts receivable.

A. **Critical Vendor** – During the past decade, the concept of the "critical vendor" has arisen in a number of operating Chapter 11 cases. Critical vendors are generally defined as vendors that furnish product to the Debtor that the Debtor could not secure under ordinary business practices from another source. A critical vendor could be a provider of a specific type of raw material, such as specialized chemicals, specialized fibers or other raw materials, and that the Debtor cannot obtain from alternative sources, in sufficient quantities, and on short notice, to continue production. Critical

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vendors could also be providers of components for the Debtor's product that the vendor specially manufactures, through proprietary processes and in accordance with the Debtor's rigid specifications.

If a vendor is designated as a critical vendor, and that vendor refuses to provide the critical product to the Debtor post-petition without having its pre-petition balance paid in full, the Debtor, after filing a motion with the Court, can pay that particular creditors pre-petition balance in consideration for the right to receive the specialized product post-petition. There is no provision for the designation of critical vendors in the Bankruptcy Code, and the critical vendor concept is in total derogation of the system for claims priority that is specified in the Bankruptcy Code. As a consequence, bankruptcy courts have become increasingly reticent to sustain a Debtor's nomination of a particular trade vendor as a "critical vendor." The quantum of proof necessary to sustain a designation as a critical vendor will be high, and a trade vendor seeking designation as a critical vendor can expect stiff opposition from, among other parties, the Debtor's secured creditors, other general unsecured creditors that are not being designated as critical vendors, and perhaps the United States Trustee.

B. **Administrative Claim for Goods Delivered** – In certain circumstances, a vendor that provided goods to the Debtor within twenty days prior to the filing of the petition will have an administrative priority claim for the value of goods that were delivered in the ordinary course of the Debtor's business. 11 U.S.C. § 503(b)(9). As a consequence, if a vendor can specifically identify invoices that were delivered to the debtor within twenty days prior to the commencement of the case, that vendor can

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assert a claim and be paid in full prior to any payments to general unsecured creditors.

In addition, under certain circumstances a Debtor may move to reclaim goods that were delivered to a debtor within forty-five days prior to the petition. 11 U.S.C. § 546(c)(1). In order to effect this state law reclamation, however, the vendor must provide a written demand for reclamation of the delivered goods either (i) not later than forty-five days after the date that the goods were delivered to the Debtor; or (ii) not later than twenty days after the Petition Date if the forty-five day period expires after the filing of the petition. Creditors should be aware that this statutory reclamation right is subject to the rights of creditors that holds prior security interests in the goods in question. As a result, the holder of a blanket lien on the Debtor's inventory or raw materials will likely have a claim to the goods that is superior to the vendor's reclamation rights.

XIII. EXECUTORY CONTRACTS

The Debtor will likely have a number of outstanding "executory contracts." Executory contracts are contracts between the Debtor and other entities that have not been fully performed by the parties. Typical examples of executory contracts are licenses of technology, leases, supply agreements and other service contracts. As a general proposition, the Debtor has the right to either assume or reject its executory contracts. Assuming or rejecting contracts carries with it distinct benefits and obligations for the Debtor and the contracting party.

A. Automatic Termination Clauses – Clauses that provide that the contract will automatically terminate upon the filing of a bankruptcy, known in bankruptcy jargon as "ipso facto" clauses, are generally unenforceable. 11 U.S.C. § 365(e)(1). There are two noteworthy exceptions to this general rule, namely:

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1) A contract to make a loan, such as a loan commitment letter, can be terminated based solely on the Debtor's filing of a bankruptcy, 11 U.S.C. § 365(e)(2)(B); and

2) If applicable non-bankruptcy law excuses the non-debtor party from rendering or accepting performance under the contract, such as in the case of a license of intellectual property, and the non-debtor party to the contract does not agree to perform under the contract, then the contract is terminated. 11 U.S.C. § 365(e)(2)(A).

B. **Assumption of Contracts** – If the Debtor assumes a contract, the Debtor can enjoy the benefits of the contract, either post-petition or subsequent to the confirmation of the Debtor's plan of reorganization (the "Plan"). If the Debtor chooses to assume a contract, however, it must "cure" any defaults under the contract, including any arrearages that are due under the contract. 11 U.S.C. § 365(b)(1)(A). Assumption of a contract often becomes a negotiation between the Debtor and the contracting party, because the contracting party is often willing to compromise the amount of its "cure" claim in order to preserve its working relationship with the Debtor. Thus, a vendor or supplier that wishes to retain the income stream from the Debtor's business may be willing to accept a reduced cure amount in order to secure the benefit of the Debtor's business going forward.

C. **Rejection of Contracts** – If the Debtor rejects a contract, the Debtor no longer has to perform, or accept performance, under the contract. This allows the Debtor to escape a relationship where the Debtor was either (i) dissatisfied with the vendor's goods or services, or (ii) obligated to pay an amount that was above market price for the goods, services or leasehold in question. Rejecting a contract gives rise to a claim against

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the Debtor, however, that is tantamount to a breach of the contract as of the petition date. 11 U.S.C. § 365(g). Thus, a Debtor that rejects a number of contracts should obligate itself to a large volume of general unsecured claims. These claims could have a significant impact on whether the Debtor can confirm a Plan, as well as the amount that may be available for payment to the Debtor's unsecured creditors under the Plan. As a consequence, the Committee will carefully watch the Debtor's decisions as to whether it will assume or reject its contracts, and the Debtor must carefully consider whether the rejection of a contract will impair its ability to confirm its Plan.

D. **Assignment of Executory Contracts** – A Debtor may assume, and then assign, its executory contracts. 11 U.S.C. § 365(f)(1). This is often the foundation of the sale of the Debtor's business under 11 U.S.C. § 363, as it allows the Debtor to assume beneficial contracts and then assign them to the entity that is purchasing the Debtor's business as a going concern. The other party to a contract with the Debtor cannot object to its assumption and assignment based solely on a provision in the contract that prohibits the assignment of the contract. 11 U.S.C. § 365(f)(1). Before the Debtor can assume and assign a contract, however, the Debtor has to pay any cure associated with that contract or ensure that the assignee of the contract will pay the cure amount. 11 U.S.C. § 365(f)(2).

E. **Licenses of Intellectual Property** – Many corporations' business model is totally dependent on technology that is licensed from another party. If the licensing party files bankruptcy, the Bankruptcy Code will allow the Debtor to reject the license contract. 11 U.S.C. § 365. The recipient of the license has rights under the Code, however, that will allow it to continue to retain the license, and use the technology

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inherent in the license, until the license expires by its own terms. 11 U.S.C. § 365(n). The licensee will be required to continue making royalty payments during the term of the license. 11 U.S.C. § 365(n)(2)(B). Obviously, corporations that are dependent on a given license from a bankrupt corporation should carefully monitor the case, and should enter into proactive negotiations with the Debtor early on regarding the Debtor's intentions with regard to the licensed technology.

The Bankruptcy Code provides that contracts shall only be assignable to the extent that assignment is otherwise permissible under other applicable state or federal law. 11 U.S.C. § 365(c)(1)(A). Certain provisions of the United States Code prevent a licensee of intellectual property from assigning its license rights to a third party without the permission of the licensor. Thus, if the Debtor is a licensee of intellectual property that is crucial to the operation of its business, the Debtor cannot assume its licenses and convey them to an entity that is purchasing the Debtor's business as a going concern, pursuant to 11 U.S.C. § 363, unless the licensor/owner of the intellectual property consents to the assignment. This can obviously be a point of intense negotiations if the Debtor's Plan is to sell or liquidate a certain portion of its business that is totally dependent on a given license of intellectual property.

F. Leases of Commercial Property – The Debtor has the ability to either assume or reject its leases of real property. For businesses with multiple locations, particularly retailers, this can be a powerful tool, as it allows the Debtor to reject leases for stores that are not profitable, or are not profitable at the current rental rate. Under this scenario, a Debtor may inform its landlords of its intention to reject their lease on a given date post-petition. This may give rise to negotiations between the Debtor and the landlord as to whether the landlord would be willing to accept a reduced rental

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rate in order to retain the Debtor as a tenant. This type of negotiation can begin shortly after the petition date, and can last up until the date for confirmation of the plan.

The Debtor may choose to assume leases for locations that are either profitable or essential to the Debtor's continuing business. If the Debtor assumes a lease of commercial real property, the Debtor must (i) cure any rental arrearage, and certain non-monetary defaults, and (ii) provide "adequate assurance" that it can continue to perform under the terms of the lease. 11 U.S.C. § 365(b)(1)(A). This is true whether the Debtor assumes and retains the contract or proposes to assume the contract and assign it to another party. There are certain other more restrictive provisions regarding the financial wherewithal and projected rent due from an assignee of a commercial shopping center lease. 11 U.S.C. § 365(b)(3)(A)-(D).

If the Debtor rejects a lease of commercial property, this will give rise to rejection damages. In the case of a commercial lease, however, rejection damages are limited to the greater of:

a) one year of rent; or

b) 15%, not to exceed three years, of the remaining rent due under the lease;

whichever is greater. 11 U.S.C. § 502(b)(6). If the landlord obtained a letter of credit to secure performance under the lease, and the amount of the letter of credit exceeds the amount of permissible rejection damages, the lessor may only draw upon the letter of credit up to the amount of the quantified rejection damages.

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XIV. ADEQUATE PROTECTION AND RELIEF FROM THE AUTOMATIC STAY

Even though the automatic stay prevents a creditor from taking action to foreclosure upon or recover its collateral, the creditor is not forced to wait throughout the course of the case to recover its collateral if the debtor is not adequately protecting the collateral, or the debtor has no value in the collateral. There are two specific motions that a debtor can use in an attempt to better protect its interests in its collateral.

A. Motion for Adequate Protection – A creditor can move the court for an order forcing the Debtor to provide a secured creditor with "adequate protection". 11 U.S.C. § 361. Adequate protection can take the form of periodic payments to the creditor, or the provision of additional security to prevent the value of the secured creditor's collateral from decreasing.

As a general proposition, when the value of a creditor's collateral exceeds the balance due to that creditor under the debtor's loan obligations, the creditor may be entitled to adequate protection payments in order to ensure that the debtor's loan balance does not continue to increase, such that the creditor's equity in its collateral would decrease. These payments can be prescribed by an order of the court that is either consensually agreed upon between the debtor and the creditor, or entered by the court after an evidentiary hearing. Further, as a general rule, if the creditor does not have any "equity" in its collateral, because the debtor's loan balance exceeds the value of the collateral, that creditor is not entitled to adequate protection payments, as the equity position has already decreased to zero, and further accrual of the debt will not result in an increase in the creditors allowed secured claim. 11 U.S.C. § 506(b).

B. Motion for Relief from Stay – A creditor can seek authorization from the bankruptcy court in order to proceed with its state law and contractual rights and

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remedies against its collateral. The creditor pursues this authorization through a motion for relief from the automatic stay. The court can grant a creditor relief from the automatic stay under two conditions:

1) Cause, including the lack of adequate protection of the creditor's interest in the property, 11 U.S.C. § 362(d)(1); or

2) A situation where the debtor has no equity in the collateral property, and the collateral property is not necessary for the debtor's effective reorganization. 11 U.S.C. § 362(d)(1)(A) & (B).

Under 11 U.S.C. § 362(d)(1), it would be appropriate for a court to lift the automatic stay in a situation where the debtor is not adequately protecting the collateral, such as by failing to adequately ensure the collateral or failing to pay property, ad valorem or excise taxes due on the property. Creditors can closely monitor the debtor's activities with regard to the payment of insurance and taxes through the monthly operating reports, and can swiftly file a motion for relief from stay if the debtor fails to perform these very basic and important duties.

If the creditor obtains an appraisal of the collateral property, and the balance due under the debtor's obligations to the creditor exceeds the value of the property, the creditor can move for a relief from the automatic stay. The creditor must also prove, however, that the property is not necessary for an effective reorganization of the debtor. In many cases, particularly those involving real property assets, this may be a substantial impediment to obtaining relief from the stay, as the collateral property may be some of the debtor's only income producing assets. This requirement is not always fatal to a motion for relief, however, because the property must not only be necessary for an effective reorganization, but the debtor must have a realistic prospect of filing and confirming a plan of reorganization. Accordingly, if

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the debtor's monthly operating income or operating capital is not sufficient to realistically sustain a plan of reorganization, a creditor may move for relief from the automatic stay on the grounds that there is no "equity" in the collateral property, and the debtor, despite its best efforts, does not have a realistic possibility of filing and confirming a Plan.

XV. FILING AND TREATMENT OF CLAIMS

Entities to whom the Debtor owes money for goods, services or money lent pre-petition must file a claim against the Debtor in order to receive any form of payment on account of the amounts owed. Claims are asserted against the Debtor by filing a proof of claim with (i) the Clerk of the Court; or (ii) a claims agent that is retained and designated by the Debtor. ***Creditors should carefully review claims notices to determine exactly where proofs of claim should be filed.***

There are five primary classes of claims:

1) **Secured** – Secured claims are claims that are supported by either (i) a consensual security interest in the Debtor's property that has been properly perfected by filing in the applicable public records, or (ii) a judgment lien or mechanics lien that has been perfected in accordance with state law. Secured claims are generally entitled to by paid first from the proceeds of the collateral property of the Debtor, prior to any payments to other classes of creditors. The priority amongst multiple secured creditors is generally determined by the date on which the various creditors perfected their respective liens against the Debtor's property.

2) **Administrative Priority** – Administrative priority claims are those claims that arise in connection with the administration of the case and the Debtor's operations post-petition. These claims, which can include professional fees and certain goods and services furnished to the Debtor post-petition, are delineated in 11 U.S.C. § 503(b).

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3) **Tax** – Tax claims generally include all claims by local, state or federal taxing authorities for any types of tax obligations due from the Debtor. Some specific types of tax claims may be entitled to priority treatment. The assessment, perfection and treatment of the various tax claims has been the subject of numerous and lengthy textbooks. Suffice it to say that the intersection of bankruptcy and tax law is complicated, and beyond the scope of this toolbox.

4) **Priority** – Certain types of claims, including allowed administrative claims and certain tax claims, are designated as priority claims. The categories of claims that are entitled to priority include, but are not limited to:

i) domestic support obligations of the Debtor;

ii) pre-petition wages of employees of the Debtor up to $10,950 for work done during the 180 days prior to the filing;

iii) employment taxes on these pre-petition wages; and, among other things,

iv) customer deposits up to $2425;

v) allowed Administrative Priority claims; and

vi) certain tax claims.

11 U.S.C. § 507(a). Priority claims are entitled to payment in full prior to any payments to general unsecured creditors. The priority with which these priority claims will be paid is specified by 11 U.S.C. § 507(a)(1)-(10).

5) **General Unsecured** – General unsecured claims are claims for which the holder has not obtained a perfected security interest in the Debtor's property. These claims can include, but are not limited to, claims for goods and services delivered, claims for breach of contract, personal injury claims and other claims that have not been liquidated and reduced to a perfected judgment lien.

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In almost every case, a bar date will be set before which entities must file their proofs of claim against the Debtor. ***Counsel should beware that in some districts bar dates are automatically set by reference to some event, typically the 341 First Meeting of Creditors. In order to be safe, it is advisable for a creditor to prepare and file a Proof of Claim as soon as possible after the case is filed.*** A timely filed proof of claim can always be amended, but a proof of claim that is not filed by the bar date will, in most cases, be disallowed.

Once the creditors have filed Proofs of Claim of record, the Debtor or the Trustee, as appropriate, will review the claims for (i) sufficiency of supporting documentation; and (ii) accuracy of the claim relative to the amount shown on the Debtor's books and records. If the Debtor or the Trustee determines that the claims are (i) not properly supported; (ii) overstated as to amount; or, (iii) mischaracterized in terms of collateral or priority, the Debtor or the trustee will file an objection to the claim. An objection to a creditor's claim is a contested matter, and the parties will therefore be able to use discovery and other litigation procedures in order to gather adequate information to resolve the claim. An objection to claim that cannot be consensually resolved may ultimately subject to evidentiary trial before the Bankruptcy Court.

XVI. FILING AND CONFIRMATION OF A PLAN

In order for a Chapter 11 or 13 Debtor to emerge from bankruptcy, the Debtor must file, and confirm, a Plan of Reorganization. The Plan of Reorganization will specify, among other things, (i) which creditors the Debtor intends to repay, (ii) the amounts to be repaid to each creditor, and (iii) the means by which the Debtor will generate the funds necessary to make the payments to creditors. A Plan can be either (i) a liquidating plan, wherein the Debtor proposes a specific orderly liquidation of its assets, or (ii) an operating plan, where the Debtor proposes to reorganize its debts and repay them from operating income, or (iii) a Plan where the Debtor proposes to sell its ongoing

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business and thus all of its assets, as a going concern. Creditors holding claims against the Debtor will be allowed to vote on the Plan.

A. **Unimpaired and Impaired Claims** – A claim against the Debtor is deemed "unimpaired" if it will be paid in full according to its terms. 11 U.S.C. § 1124(1). Certain creditors, such as the Debtor's equity holders and those creditors whose claims are not impaired, will not be allowed to vote for the Plan. All other creditors' claims will be classified, and will be allowed to vote on the Plan.

B. **Classification of Claims** –Creditors whose claims are impaired, and will not be paid in full according to their terms, will be grouped into various classes of creditors. Creditors in any given class of creditors must have similar claims that will be afforded similar treatment under the Bankruptcy Code. 11 U.S.C. § 1123(a)(4). It is impermissible for the Debtor to strategically schedule similar claims in different classes for the sole purpose of enhancing its chances of confirming its plan of reorganization.

C. **Contents of the Plan** – At a minimum, a Plan must, among other things:

1) identify the classes of claims;
2) Specify the various classes of claims that are not impaired;
3) Specify the treatment of every class of claims; and
4) provide the means by which the Debtor will implement the plan, including whether the Debtor will retain property, sell property, change the terms of any outstanding loan obligations or otherwise merge or consolidate its business with another entity.

11 U.S.C. §§ 1123(a)(1), (2), (3), and (5). The plan may include provisions regarding the assumption or rejection of executory contracts, 11 U.S.C. § 1123(b)(2), the

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modification of secured claims, 11 U.S.C. § 1123(b)(5), and the settlement or resolution of pending and disputed claims held by the Debtor and pending and disputed against the Debtor. 11 U.S.C. § 1123(b)(3). In addition, in the context of a liquidating plan, the plan may provide for the sale of some or substantially all of the Debtor's assets pursuant to a specified sale mechanism.

D. **The Disclosure Statement** – Prior to circulating a Plan for creditors to vote upon in connection with confirmation of a Plan, the Debtor must prepare and circulate a Disclosure Statement, which is a pleading that is designed to provide an investor holding claims typical to the Debtor's creditors "adequate information," 11 U.S.C. § 1125(a)(1), that will allow a hypothetical investor to make an informed decision on whether to vote for the Debtor's Plan. 11 U.S.C. § 1125(b). Disclosure Statements typically detail the Debtor's past financial performance, the attributes of the Debtor's management and leadership, the Debtor's current assets and anticipated post-confirmation income, any governmental approvals that will be necessary to consummate the Plan, and a detailed description of the means and methods by which the Debtor will implement its plans. The Court will hold a hearing on whether the disclosure statement, does, in fact, provide adequate "adequate information" to creditors who will be making a decision on whether to confirm the plan. Once the Debtor has obtained an order from the Court approving the Disclosure Statement, the Debtor can circulate the Plan and Disclosure Statement to all creditors.

The hearing on the Disclosure Statement can be an important event in the case, as creditors whose rights may be modified by the Plan will want to insure that other classes of creditors fully understand the Debtors plan before they are asked to vote on the Plan. As a consequence, negotiations regarding the contents of the

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Disclosure Statement can be intense. Many creditors use the Disclosure Statement hearing as an opportunity to present the Bankruptcy Court with a preview of the issues that will be presented at the hearing on confirmation of the Debtor's Plan. Creditors that raise objections to the Debtor's Disclosure Statement should be wary, however, that many bankruptcy judges will want to confine the hearing on the Disclosure Statement to issues that truly impact the contents of the Disclosure Statement, and may be unwilling to spend a significant amount of courtroom time entertaining arguments regarding the contents and provisions of the Plan at the Disclosure Statement hearing.

E. **Plan Voting** – After the Disclosure Statement has been approved by the Court, the Debtor will circulate the Plan to all creditors for voting. Typically, the Plan will be sent as part of a packet that includes the Plan, the Disclosure Statement and a ballot for voting purposes. Counsel for a creditor should take care to instruct the mail department to deliver packages that contain Plans and ballots to corporate counsel immediately, as there is often a relatively tight deadline before which the ballots must be returned in order for that creditor's vote to be effective.

F. **Plan Confirmation** – After the Plan has been circulated to creditors, and the ballots have been counted, the Court will set a hearing for confirmation of the plan. Confirmation of a plan will often be contested. As a consequence, the confirmation hearing often becomes a heavily litigated trial proceeding, with parties presenting evidence regarding the feasibility of the Plan and the Debtor's ability to consummate its Plan.

In order for a plan to be confirmed, such that it will govern the relationship between the Debtor and its creditors post-confirmation, the plan must meet a number

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of specific requirements. Those specific requirements are set out in 11 U.S.C. § 1129, and include, among other things,

1) that the plan has been proposed in good faith;
2) that the Debtor has disclosed the identity of any individuals that the Debtor anticipates serving as an officer, director or voting trustee under the Plan;
3) that any governmental agency or regulatory commission that must approve the rates that the Debtor will use post-confirmation have approved said rates;
4) that each holder of a claim has either accepted the Plan, or will retain under the Plan, property that has a present value that is at least equal to the amount that that creditor would receive if the Debtor's assets were liquidated under Chapter 7 and distributed to creditors;
5) that the plan is feasible, and is not likely to be followed by liquidation or the need for further financial reorganization; and
6) that certain specified administrative costs associated with the case have been paid in full on or before the specified date that the Plan becomes effective (the "Effective Date"). If that Debtor fails to meet any of the specific requirements specified by 11 U.S.C. § 1129(a), then the Plan cannot be confirmed, regardless of whether each designated class of creditors has voted to accept the Plan.

In order for the Plan to be confirmed, the Plan must be accepted by one class of impaired creditors. A class of impaired creditors is deemed to accept the Plan if at least of one-half of the creditors in that class who cast ballots have voted to accept the plan, and at least two-thirds of the amount of claims held by those creditors that have voted choose to accept the Plan. 11 U.S.C. § 1126(c). If the ballots cast by creditors

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in a given class do not meet these two requirements, then the class is deemed to have rejected the plan.

G. Cram Down – Cram down is an often used, and often misunderstood, term in the context of a bankruptcy case. A Debtor may "cram down" its Plan, and force a dissenting class of creditors to abide with the terms of the Plan, if:

(1) at least one class of impaired creditors votes for the Plan; and,

(2) the Plan provides "fair and equitable" treatment for the non-consenting class. For purposes of confirmation, "fair and equitable" has different definitions depending upon the character of the claim.

If a creditor's claim is secured, the Debtor can only cram the Plan down if:

a) the Plan provides that the secured creditor will retain its lien on the Debtor's property to the extent of the amount of its allowed claim; and

b) will receive payments under the plan, over time, that have a net present value equal to the value of that creditor's lien against the Debtor's assets.

11 U.S.C. §§ 1129(b)(2)(A)(i)(I)&(ii). With respect to unsecured claims, the plan must provide that

c) the holder of a claim will receive property as of the Effective Date, equal to the value of their claim; or

d) that no class of creditors that are junior in priority to that creditors class will receive any distributions under the plan until the creditor in the senior class has been paid in full.

11 U.S.C. § 1129(b)(2)(B)(i)(II). In other words, if creditor is a secured creditor, it must receive payments under the Plan equal to the net present value of its allowed

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secured claim, which will equal the value of the collateral securing the claim. 11 U.S.C. § 506.

One important issue that is often considered at confirmation is whether the Debtor's Plan provides for the secured creditors' debt obligation to accrue interest post confirmation at an appropriate rate. Where there is an efficient market within which the Debtor could obtain similar loan financing, the rate dictated by that market will control. Otherwise, the post-confirmation rate of interest is generally determined by looking at the existing prime rate of interest and then applying an appropriate rate premium to account for the risk inherent in lending to a distressed borrower such as a Chapter 11 Debtor.

XVII. THE EFFECT OF CONFIRMATION

Upon the entry of an Order confirming the Plan, the terms of the Plan bind the Debtor and any creditors and the holders of equity in the Debtor. Upon confirmation of the Plan, title to all property of the Debtor that is not otherwise slated to be sold under a provision in the Plan, vests in the Debtor. Unless the Plan provides otherwise, confirmation of a Plan discharges all debts of the Debtor, whether or not any given creditor filed a proof of claim or accepted the plan. 11 U.S.C. § 1141(e)(1)(A). After confirmation of the Plan, creditors holding claims against the Debtor will only be able to recover the amounts that are provided for in the plan, and will no longer be able to insist on full payment of their debts, regardless of whether the creditor has filed a proof of claim in the action. Obviously, the discharge provisions of 11 U.S.C. § 1141 are one of the most compelling reasons that creditors must pay close attention to the progress of a bankruptcy case. Creditors must instill in their organization the urgency of transmitting bankruptcy documents to counsel as soon as possible in order that counsel can review the pleadings and take appropriate action to protect the creditor's interests.

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As a general proposition, the Plan constitutes a new contract between the Debtor and its creditors. A creditor's rights with regard to a default by the Debtor under the terms of the Plan will generally be determined by the provisions of the Plan itself. The Plan will often provide that the Bankruptcy Court retains jurisdiction over the case to resolve post-confirmation disputes. It is wise, however, for creditors to insist upon language in the Plan that allows the creditor to exercise its contractual rights upon a default under the terms of the Plan without having to return to Bankruptcy Court for authority to exercise its rights.

XVIII. SPECIAL TYPES OF DEBTOR

There are several types of Debtors who will receive special treatment, or have special obligations under the Bankruptcy Code. These Debtors are as follows:

A. **Single Asset Realty Debtors** –A single asset realty Debtor, or "SARE" is defined as a Debtor whose sole property constitutes a single property or project that generates substantially all the gross income of the Debtor. 11 U.S.C. § 101(51)(B). A typical single asset realty Debtor can own either (i) a single warehouse, hotel, office building or other piece of income producing property or (ii) a single apartment complex, office park or industrial park with a number of separate income producing properties owned by the same entity; or, (iii) an integrated development such as condominium development, golf resort development or other mixed use planned community.

If a Debtor is deemed to be a SARE, it must either

1) file a plan of reorganization within 90 days from the petition date that has reasonable possibility of being confirmed within a reasonable time or

2) begin making monthly payments to its secured creditors in an amount equal to the interest-only payment due to the creditor at the applicable non-default

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rate of interest for a loan amount equal to the value of that secured creditor's collateral.

3) 11 U.S.C. § 362(B)(3). Under the current provisions of the Bankruptcy Code, a SARE no longer has the option of simply filing its petition and "hanging out" in bankruptcy while it waits for the market to turn around or for its real property assets to sell. Instead, the SARE must be willing to actively and expeditiously move forward with confirmation of a Plan or begin paying interest to its secured creditors at the contract rate. However, as a general proposition, a Debtor that could pay interest to its secured creditors at the contract rate would never have filed bankruptcy in the first place. As a consequence, 11 U.S.C. § 362(d)(3) has a very restrictive effect on the ability of a single asset realty Debtor to file a Chapter 11 proceeding and obtain significant benefit from the proceeding.

B. An Individual Debtor – An individual Debtor can file plans either under Chapter 13, Chapter 7 or Chapter 11. Distinctions between these plans are, very briefly, as follows:

1. ***Chapter 7*** – Under a Chapter 7 plan, a Trustee will be appointed to administer the Debtor's assets. The Debtor will be able to exempt certain property from administration by the Trustee based upon (i) certain exemptions specified by the Bankruptcy Code, 11 U.S.C. § 522, or (ii) applicable exemptions specified by states that have affirmatively elected to opt-out of the federal exemptions and adopted their own exemptions. With the exception of the exempt assets, the Debtor will tender all its assets to the Trustee for liquidation. If an asset has no value, or it is not liquid such that the Trustee

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can readily realize value from the sale of that asset, the Trustee may abandon that asset back to the Debtor. 11 U.S.C. § 554.

Within a relatively short time period after the filing of the case, generally no more than 120 days, a Chapter 7 Debtor will be discharged from all of its debts unless a creditor objects to a discharge or the debts based on some form of prior improper conduct by the Debtor. 11 U.S.C. § 523. An objection to discharge gives rise to an Adversary Proceeding, which is governed by the Federal Rules of Bankruptcy Procedure 7001-7087. Objections to discharge are dealt with later in this paper.

After the Trustee has marshaled all of the assets of the individual Debtor, the Trustee will review the claims filed by creditors, determine which claims should be allowed and in what amount, and then distribute the proceeds from the liquidation of the Debtor's assets to pay the allowed claims. As practical matter, if an individual files a Chapter 7 case he has generally taken voluntarily steps, prior to the filing of his or her petition, to liquidate his or her assets and has used the proceeds from these sales to either support his or her lifestyle or pay off certain of his creditors. As a consequence, it is rare that a creditor will receive a significant distribution in an individual Chapter 7 estate.

2. ***Chapter 13*** – As noted above, only an individual can file a Chapter 13 case. An individual that files a Chapter 13 case generally has a limited amount of debt to reorganize. A Chapter 13 Debtor often seeks to use his or her regular ongoing income to pay his or her post-petition debts, including his home mortgage, as and when they come due, and pay the pre-petition arrearages that developed on his or her secured debts over time. In addition, a

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Chapter 13 Plan typically provides that a portion of the Debtor's post-petition income will be devoted to repaying a percentage of his or her unsecured debts. Chapter 13 Plans must be capable of being completed in sixty (60) months if they are to be confirmed. 11 U.S.C. § 1322(d).

One interesting provision of a Chapter 13 bankruptcy is the co-debtor stay, which prohibits a creditor from taking any acts, or commencing or continuing any civil action to collect a consumer debt from any individual that is jointly liable on such debt with the Debtor. 11 U.S.C. § 1301(a). The co-Debtor stay does not apply, however, i) to debts where the co-debtor became liable on such debt in the ordinary course of his business, such as a personal guaranty of business credit, or ii) when the Debtor's case has been closed, dismissed or converted to a case under Chapter 7 or Chapter 11. 11 U.S.C. § 1301(a)(1)-(2).

3. ***Chapter 11*** – In an Chapter 11 action for an individual, many of the obligations and procedures that are prescribed for a corporate Chapter 11 Debtor will apply. The individual Debtor will still be required to file monthly operating reports, maintain his post-petition obligations as they become due, and propose and prosecute the confirmation of a Plan. One interesting distinction with an individual Chapter 11 Debtor, however, is that any property that the Debtor acquires between the date that the case is filed and the date that the case is either closed, dismissed or converted to a Chapter 7 becomes property of the Debtor's estate, and can thus be used to satisfy his debts. Further, all earnings of the Debtor from services performed after the commencement of the case become property of the estate. 11 U.S.C. § 1115(a)(1). If an allowed unsecured creditor objects to the confirmation of

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the individual's proposed Chapter 11 Plan, the Plan cannot be confirmed unless it provides that the property that the Debtor intends to distribute under the Plan is not less than the Debtor's disposable income, as defined by the Bankruptcy Code, during i) the five-year period following the date that the first payment is due under the Plan, or ii) any period for which the Plan proposes payments. 11 U.S.C. § 1129(a)(15). If an individual Chapter 11 Debtor proposes to pay one of his or her creditors, such as a holder of a long-term residential mortgage, over a period of time longer than five years, the Debtor must devote his or her disposable income to the payment of creditors for the entire term of the longest payment obligations. Id. As a consequence, individual Chapter 11 Debtors may find themselves locked into the payment obligations that they must pay out of their future income for time periods that are either totally untenable, or are not the result that the Debtor sought from the filing of the bankruptcy.

C. **Small Business Debtors** – The Bankruptcy Code defines a "small business debtor" as a corporate debtor that (i) has aggregate, non-contingent liquidated secured and unsecured debts of no more than $2,190,000, excluding debts owed to affiliates or insiders of the Debtor, and (ii) for whom the United States Trustee has not appointed an Official Committee of Unsecured Creditors. 11 U.S.C. § 101(51D). If the Debtor is a "small business Debtor," the Debtor's case becomes a "small business case." 11 U.S.C. § 101(51C). The Debtor in a small business case faces different post-petition obligations and reporting requirements. For example, a small business Debtor must append to its Petition its most recent balance sheet, statement of operations or income statement, and federal income tax return. 11 U.S.C. § 1116(1)(a). In addition, the

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Debtor's senior management personnel must attend meetings scheduled by the United States Trustee, including initial Debtor interviews, in order to ensure that the Debtor is making progress in filing its Plan. 11 U.S.C. § 1116(2). A small business Debtor can file an abbreviated Disclosure Statement, pursuant to 11 U.S.C. § 1125(f) and Federal Rules of Bankruptcy Procedure 3016(d) and 3017.1. The small business Debtor can obtain conditional approval of the Disclosure Statement, such that the adequacy of the Disclosure Statement can be considered in conjunction with confirmation of the Plan. Federal Rules of Bankruptcy Procedure 3017.1(a)-(c).

In a small business case, the Debtor has the exclusive right to file a Plan in the case within the first 180 days after the Petition Date. 11 U.S.C. § 1121(e)(1). This "exclusivity period" can be extended by order of the Court, but the small business Debtor must ultimately file its Plan and Disclosure Statement no later than 300 days after the Petition Date. The deadlines by which the Debtor must confirm its Plan of Reorganization after it is filed can only be extended if the Debtor demonstrates, by a preponderance of the evidence, that it is likely to confirm its Plan within a reasonable period of time. 11 U.S.C. § 1121(e)(3)(A). There are other rules that govern small business Debtors, most of which are designed to provide the small business Debtor with a quicker, less expensive route by which to confirm a Plan and exit bankruptcy.

D. **Municipal Bankruptcies Under Chapter 9** – A municipal entity can seek to reorganize its debts under Chapter 9 of the Bankruptcy Code, 11 U.S.C. § 901-946. Chapter 9 adopts a substantial portion of the Bankruptcy Rules that would otherwise be applicable to a Chapter 11 corporate Debtor. 11 U.S.C. § 901. Chapter 9 bankruptcies are relatively rare, and the applicable case law is therefore not as

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developed as the case law applying to other types of Debtors. With the increasing gap between the demand for services provided by municipal entities and the drop in corresponding tax revenues, it is likely that bankruptcy courts will see an increase in the filing of Chapter 9 actions in the coming decade.

E. **Family Farmers and Fishermen Under Chapter 12** – The Bankruptcy Code defines a family farmer as:

a) an individual engaged in a farming operation whose aggregate debts do not exceed $3,544,524, not less than 50% of which arise out of a farming operation owned or operated by the Debtor and the Debtor derives at least 50% of his income from said farming operation; or

b) a family corporation or partnership in which more than 50% of the outstanding stock is held by one family, more than 80% of the value of the Debtor's assets are related to the farming operation, and the debts do not exceed $3,544,525.

11 U.S.C. § 101(18). Further, the Bankruptcy Code defines a "family fisherman" as an individual engaged in a commercial fishing operation whose aggregate debts do not exceed $1,642,500, not less than 80% of those debts arise out of a commercial fishing operation, and the fisherman receives more than 50% of his income from the fishing operation. Bankruptcies of family farmers and family fisherman are governed by Chapter 12 of the Bankruptcy Code, 11 U.S.C. §§ 1201-1231. In many respects, the provisions of Chapter 12 are a hybrid between the provisions of Chapter 11 for corporate Debtors and Chapter 13 for individual wage earners. The provisions of Chapter 12 are specialized, and counsel for a creditor of a family farmer or a family

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fisherman is advised to seek counsel from a lawyer experienced in handling Chapter 12 cases.

F. **Cross-Border Entities Under Chapter 15** – The bankruptcy amendments that Congress enacted in 2005 created a new chapter for insolvencies of corporations that are domiciled in other countries but have substantial assets in the United States. The rules governing these cross-border bankruptcy cases are incorporated in 11 U.S.C. §§ 1501-1532. The provisions of Chapter 15 provide an opportunity for the courts of the United States, as well as the trustees and debtors-in-possession, to cooperate with the courts and other competent authorities insolvency cases where the Debtor has assets in more than one country. 11 U.S.C. § 1501(a)(1)(A) (B). Chapter 15 cases are highly specialized. As a general rule, they require counsel that is familiar with the procedures in Chapter 15, particularly those that prescribe the relief that can be afforded with regard to assets of foreign Debtors that are domiciled in the United States.

XIX. AVOIDANCE ACTIONS

Avoidance actions are the bane of creditors' existence. Avoidance actions allow the Trustee in a Chapter 7 action, or the Debtor or the liquidating agent in a Chapter 11 action, to review the Debtor's transactions with its creditors and undo, or "avoid," certain transactions that occurred prior to the filing of the Petition.

A. **The Trustee as a "Hypothetical Lien Creditor"** – As a general proposition, the Trustee, or the Debtor, automatically acquires rights as of the Petition Date that are equal to those of an entity that obtained a judicial lien against the Debtor on the Petition Date. 11 U.S.C. § 544(a)(1). This will allow the Trustee to avoid certain liens against the Debtor's property that are not properly perfected, in accordance with

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applicable state law, on the Petition Date. 11 U.S.C. § 544. In addition, the Trustee, or the Debtor, may avoid certain statutory liens that attach against the Debtor's property for rent or the distress of rent. 11 U.S.C. § 545. The laws regarding whether and to what extent a Trustee can avoid a lien against the Debtor's property are complex, 11 U.S.C. § 546, and counsel for a creditor should take care to ensure that the creditor's lien rights are protected.

B. Preference Actions – In an action that is particularly annoying to creditors, a trustee or a debtor-in-possession can seek to avoid a payment that the Debtor made (i) within 90 days prior to the petition date; (ii) on account of an existing debt; (iii) that allows that creditor to receive more than it would have received under a Chapter 7 liquidation of the Debtor's assets. In the case of a transfer to an insider, this preference avoidance period is extended from 90 days to one year. Preference avoidance allows the Debtor or the Trustee to "balance the scales," and recover transfers that the Debtor made to certain of its "preferred" creditors in order to ensure that all of the Debtor's creditors received an equal, pro-rata allocation of the assets that the Debtor distributed as payments during the time period leading up to the filing of the Petition. 11 U.S.C. § 547(b)(1) (5).

Fortunately for creditors, there are certain defined exceptions that will prevent the Trustee from avoiding allegedly preferential transfers. The most important of these exceptions is the "ordinary course of business exception," which provides a defense for any transactions between the creditor and the Debtor that occurred in either i) the ordinary course of the business relationship between that creditor and the Debtor; or ii) the ordinary course of business in that particular industry. 11 U.S.C. § 547(c)(2). Thus, if a creditor was receiving regular payments from the Debtor,

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without any undue collection efforts or coercion from the creditor, such payments will generally be protected from avoidance. "Ordinary course of business" is largely a subjective standard, and a creditor that is the defendant in a preference action should immediately take steps to establish what the "ordinary course of business" was between itself and the Debtor during the 18 months prior to the filing of the Petition, and then compare that mathematical "ordinary course of business" with the 90-day preference period associated with the allegedly preferential payments.

Another defense that is available to creditors who are defendants in preference actions is the "new value exception." This defense provides an effective credit for goods and services that the creditor provided to the Debtor during the preference period for which the creditor did not receive payment or an otherwise avoidable transfer from the Debtor. 11 U.S.C. § 547(c)(4). Thus, if the creditor continued to deal with the Debtor during the preference period, and provided either services or shipped product to the Debtor for which the creditor did not ultimately receive payment, this "new value" may serve as a credit against any preference liability that might otherwise run from the creditor to the Debtor.

Finally, a creditor may avoid a preference liability if the payment that the Trustee seeks to avoid was a contemporaneous exchange with the Debtor for new value. 11 U.S.C. § 547(c). The contemporaneous exchange defense is not strictly limited to "cash on the barrelhead" transactions, but the transfer between the Debtor and the creditor must in fact be "substantially contemporaneous," within a very limited time frame, before this defense will apply.

Preference actions can be particularly frustrating to creditors because a preference action seeks to recover "good money after bad," in that the creditor not only loses most of the money that it was not paid on its account receivable, its pre-

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Petition claim, but must then pay additional money that it received from the Debtor back to the Debtor's estate. Case law interpreting 11 U.S.C. § 547 is well evolved, and the nuances of the various defenses that are available to preference defendants are complicated. Again, counsel for a creditor is advised to contact counsel that is very familiar with preference actions as soon as the creditor is served with a preference complaint.

C. **Fraudulent Transfer Actions or Conveyance** – A Trustee or a Debtor in a Chapter 11 action may avoid any transfer that the Debtor made to a third party within two years prior to the Petition Date if the Debtor either:

a) made the transfer, or incurred a debt obligation, with the actual intent to hinder, delay or defraud any entity to which the Debtor was, or became, indebted; or

b) received less than reasonably equivalent value in exchange for the transfer, and was either:

1) insolvent on the date that the transfer occurred, or became insolvent as a result of the transfer; or

2) was engaged in a business for which the property assets that it held after the transfer provided the Debtor with unreasonably small capital assets to continue its business; or

3) the Debtor intended to incur debts by virtue of the transfer that would be beyond the Debtor's ability to pay such debts as they matured; or

4) the Debtor made such transfer to or for the benefit of an insider under an employment contract and not in the ordinary course of business.

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11 U.S.C. §§ 548(a)(1)(B)(ii)(I) & (IV). The Bankruptcy Code basically breaks down fraudulent transfer transactions into two basic types. The first type of fraudulent transfer is where the evidence indicates that the Debtor made the transfer with the specific intent to defraud its creditors. A stereotypical example of this type of transfer is when a Debtor, faced with an impending judgment arising out of a lawsuit or personal obligation, transfers assets to his spouse, his children or various trusts.

The second type of fraudulent transfer is more complicated. In this type of transfer, the Debtor transfers property and does not receive reasonably equivalent value for the property transferred. Under this scenario, commercial transactions such as large loan transactions, or complicated merger and acquisition transactions, can be unwound if, at the end of the transaction, either (i) the Debtor transferred property, including security interests, that exceeded the value of the funds lent to the Trustee or the Debtor or (ii) was left with inadequate financial resources to operate its business in the ordinary course, or (iii) the Debtor was forced to pledge collateral that grossly exceeded the value of the loan proceeds.

D. **Liability for Avoided Transfers** – Under 11 U.S.C. § 550, the Trustee or the Debtor can recover either i) the property that the Debtor transferred as part of the avoided transaction; or ii) money damages equal to the value of the property transferred. 11 U.S.C. § 550(a). In addition, under certain circumstances, the Trustee may recover the property conveyed from a secondary transferee that receives the funds or avoided property from the initial transferee. The Trustee may not recover the property or the value of the property, however, from a secondary transferee that takes the property

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for value, in good faith without knowledge that the property was the subject of an avoidable transaction. 11 U.S.C. § 550(b).

XX. INVOLUNTARY PROCEEDINGS

If creditor senses that a Debtor is routinely making transfers of its assets to preferred creditors or insiders at a time when the Debtor is insolvent, the creditor may seek to place that debtor into an involuntary bankruptcy proceeding. 11 U.S.C. § 303(a). If the debtor entity has fewer than twelve creditors, one creditor may file an involuntary bankruptcy proceeding against the Debtor. 11 U.S.C. § 303(b)(2). If the debtor has more than twelve creditors, however, there must be three or more creditors, each of which holds a non-contingent claim against the debtor that is not subject to bona fide dispute, and these claims must aggregate at least $13,475 more than the value of any collateral that those creditors may hold. 11 U.S.C. § 303(b)(1). In other words, if the Debtor has more than twelve creditors, at least three creditors must come together to file the involuntary petition, and those creditors must have either general unsecured claims that aggregate more than $13,475.00, or undersecured claims, the deficiency of which exceeds $13,475.00.

An involuntary petition is tantamount to a civil lawsuit. Once the involuntary petition is filed, the Debtor has thirty days to formulate and file an answer that disputes whether the Debtor is in fact insolvent. If the Debtor files such an answer, the court, after notice and hearing, will hold an evidentiary hearing to determine whether the Debtor is in fact insolvent. In the period between the filing of the involuntary petition and the entry of an ordered adjudicating the Debtor to be bankrupt, also known as the “gap period”, the debtor can continue to operate its business as debtor-in-possession. 11 U.S.C. § 303(f).

If the debtor is in fact insolvent, and has in fact been engaging in impermissible transactions, an involuntary petition can be a valuable tool that will authorize a trustee to examine, and potentially avoid, these transactions. Creditors must be careful, however, because the penalties for a petitioning

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creditor that files an involuntary petition in bad faith are severe, and can include punitive damages. 11 U.S.C. § 303(h)-(j). As a consequence, creditors should carefully consider all the ramifications of initiating an involuntary proceeding before they file an involuntary petition.

XXI. DISMISSAL OR CONVERSION

If a debtor in possession is not moving forward with the steps necessary to confirm a plan, or is not otherwise meeting its obligations as a debtor-in-possession, a creditor may move to dismiss the Chapter 11 case or convert it to a Chapter 7 liquidation. 11 U.S.C. § 1112. The Bankruptcy Code suggests a laundry list of factors that will support the dismissal or conversion of a Chapter 11 case, including:

1) a substantial or continuing loss of the estates;
2) the absence of any reasonable likelihood of rehabilitation of the Debtor;
3) gross mismanagement of the Debtor's assets;
4) failure to maintain adequate insurance on the Debtor's assets;
5) unauthorized use of cash collateral that is substantially harmful to a creditor;
6) unexcused failure to timely file monthly reports and other reports required of the debtor;
7) failure to attend the 341 first meeting of creditors or a Rule 2004 examination;
8) failure to timely provide information or attend meetings requested by the United States Trustee;
9) failure to timely pay taxes that accrued after the Petition Date;
10) failure to file a disclosure statement or confirm a Plan within the time periods fixed by the Bankruptcy Code;
11) failure to pay any United States Trustee fees; or
12) the inability to successfully consummate a confirmed Plan; or

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13) a material default by the debtor under a confirmed Plan.

11 U.S.C. § 1112(a)(4). If the case is dismissed, the Debtor's creditors are free to exercise their state law or contractual rights against the Debtor's assets. If the case is converted to a Chapter 7 action, a Trustee will be appointed to liquidate the Debtor's assets and pay its claims pro-rata.

A court may not convert a Chapter 11 case to a Chapter 7 liquidation if: (a) the Debtor has been removed from its position as debtor-in-possession by the prior appointment of a Trustee; (b) the case was originally commenced as an involuntary petition; (c) the Debtor is a farmer; or (d) the Debtor is a corporation that is not a moneyed, business or commercial corporation, such as a church or charitable institution. 11 U.S.C. §1112(c).

A creditor may move the Court to dismiss a case during the early days of the case if the case has been filed in "bad faith". While the Bankruptcy Code does not define "bad faith," there is substantial case law that defines a bad faith filing as a filing that was made:

a) when the Debtor has few employees;

b) when the Debtor has few unsecured creditors;

c) when the case is essentially a two-party dispute with its secured creditors;

d) when the case was filed on the eve of foreclosure of the Debtor's assets; or

e) when the debtor's primary assets serve as collateral for a secured debt that is in default.

If a debtor files a case on the eve of a scheduled foreclosure in order to delay the foreclosure, and thus presumably save its collateral asset, the Court will sometimes dismiss the case, and allow the creditor to proceed with the exercise of its state law and contractual rights. *See e.g.*, In Re Albany Partners, Ltd., 749 F.2d 670 (11th Cir. 1984); In re Phoenix Piccadilly, 849 F.2d 1393 (11th Cir. 1988).

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XXII. CONCLUSION AND PARTING THOUGHTS

The Bankruptcy Code can be logical and orderly, and it can function to efficiently administer assets, restructure debt and pay claims. At the same time, the Code can be complex, in some respects ambiguous, and subject to varying interpretations from court to court. The practice of bankruptcy law is a fascinating discipline, but it requires unending study and analysis of the Bankruptcy Code and the case law that interprets the Code. If a corporation does not have in-house counsel that is familiar with the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure and the procedures that govern bankruptcy courts, it is advisable for corporate counsel to seek out trained bankruptcy counsel in order to best protect the client's rights in any bankruptcy proceeding.

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