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407 - Winning Solutions in an Uncertain Economy — Current Legal Issues in Bankruptcy

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Session 407

Faculty Biographies

David Giles

David Giles is senior counsel - business and project development for Valero Energy Corporation in San Antonio, Texas.

Prior to joining Valero, he held positions at Clear Channel Communications, Thompson & Knight LLP, and Cox Smith Matthews, Inc.

He is a member of the State Bar of Texas and ACC. He has been named as a "Best Lawyer" by S.A. Magazine for mergers, acquisitions and business law.

Mr. Giles holds a BA from the University of Arkansas and a JD from the University of Texas.

John Marziotti

John D. Marziotti is general counsel and secretary of Newfield Exploration Company, based in Houston, TX.

Previously, Mr. Marziotti was legal counsel for Newfield. Prior to joining Newfield, he was a partner with the firm of Strasburger & Price L.L.P. in their Houston office.

He is a member of the State Bar of Texas, ACC and the Texas General Counsel Forum.

Mr. Marziotti holds a BA from the College of Charleston and a JD from Southern Methodist University.

Deborah Williamson

Deborah Williamson is the department leader of Cox Smith's Creditor's Rights, Restructuring and Bankruptcy Department and is board certified by the Texas Board of Legal Specialization and by the American Board of Certification in Business Bankruptcy Law. Ms. Williamson advises clients on all aspects of business bankruptcy, including acquisitions, pre-bankruptcy strategic planning, fraudulent conveyances, lending, and complex issues in real estate and commercial transactions.

She is past president of the American Bankruptcy Institute, past chair of the State Bar of Texas Bankruptcy Law Section and former director and secretary of the American Board of Certification. Former executive editor and current author of Bench Notes Column, 'ABI Journal', Ms. Williamson is also past chair of the Examination Committee for Texas Board of Legal Specialization (Bankruptcy), fellow of American College of Bankruptcy and director of US-Mexico Bar Association. Additionally, she is past treasurer of the

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American Board of Certification and former chair of the Texas Board of Certification, Bankruptcy Law Commission.

Ms. Williamson currently serves as director and member of the executive committee of the San Antonio Public Library Foundation.

She received her BA with honors from the University of Texas at El Paso and graduated cum laude from the University of Houston Law Center.

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WINNING SOLUTIONS IN AN UNCERTAIN ECONOMY

Current Legal Issues in Bankruptcy

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WINNING SOLUTIONS IN AN UNCERTAIN ECONOMY: CURRENT LEGAL ISSUES IN BANKRUPTCY

Today's financial environment serves as a reminder that the potential for a bankruptcy lurks around every corner of every transaction. An entity may choose to file bankruptcy for a host of reasons. Sometimes a bankruptcy filing will be precipitated by involvement in litigation. Just as often, a party to pending litigation may file for reasons unconnected to the litigation—for example, any of the following may be the predicate for the filing of a bankruptcy case: (i) the licensor of a copyright may find itself in financial difficulties; (ii) a licensee of a patent may hit a liquidity wall; (iii) a landlord might default on its secured debt; (iv) a tenant might decide that its lease is above-market; (v) the potentially insolvent holder of a coveted asset might seek to sell assets; (vi) a buyer of assets might decide that the purchase price was too high; or (vii) creditors may assert that a buyer of assets got "too good" a deal. While this list is no way exhaustive, the situations presented serve to illustrate the commonality of financial turmoil and bankruptcy.

While the current financial markets make it clear that little can be done to fully protect against a potential bankruptcy, it may be possible for parties affected by the bankruptcy to mitigate injuries or even benefit from the event.

This brochure is designed to outline in general terms the bankruptcy process and highlight some of the key issues that in-house counsel may need to address. Accordingly, the brochure is divided into six separate sections addressing the following topics:

- The first section of the brochure addresses some of the issues arising upon the commencement of a bankruptcy case, including: (i) what is the controlling law; (ii) who are the key players in the case; (iii) what is the venue for the case; and (iv) what is the “bankruptcy estate?”
- The second section of the brochure addresses the automatic stay, its effect, and under which circumstances the stay can be lifted.
- The third section of the brochure addresses the bankruptcy claims process, including discussions of the following: (i) the various claim types; (ii) the claims filing process; (iii) the claims allowance and disallowance processes; and (iv) ancillary claims issues.
- The fourth section of the brochure addresses various common litigation issues involving a debtor in bankruptcy.
- The fifth section of the brochure focuses on acquisitions and sales occurring under section 363 of the Bankruptcy Code.
- The sixth and final section of the brochure discusses a variety of other common issues arising in bankruptcy cases, including: (i) real estate issues; (ii) intellectual property issues; and (iii) merger and acquisition issues.

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THE COMMENCEMENT OF THE BANKRUPTCY CASE

I. The Controlling Law—The Bankruptcy Code

The Bankruptcy Code is a Federal statute and is codified under title 11 of the United States Code. The Bankruptcy Code is divided into nine chapters, with Chapters 1, 3 and 5 containing general provisions that are generally applicable in all bankruptcy cases. Chapters 7, 9, 11, 12, 13 and 15 contain provisions particular to the various types of bankruptcy cases, and the provisions within these six chapters generally apply only to relief sought under that particular chapter. Individually, the different chapters of the Bankruptcy Code break down as follows:

A. Chapter 1 of the Bankruptcy Code contains definitions and other general provisions.

B. Chapter 3 governs case administration, including the commencement of a case, some of the parties to a bankruptcy case, and the administrative powers of a bankruptcy court.

C. Chapter 5 deals with the relationship between creditors, the debtor and the bankruptcy estate.

D. Chapter 7 governs the traditional liquidation bankruptcy during which a Trustee is appointed and the debtor's non-exempt assets are sold or otherwise disposed of to satisfy the claims of creditors.

E. Chapter 9 contains the provisions dealing with the adjustment of debts of a municipality or other taxing authority.

F. Chapter 11 provides for reorganization, but it often involves a sale or liquidation.

G. Chapter 12 provides for the adjustment of debts of a family farmer or fisherman.

H. Chapter 13 relates to efforts by individuals to reorganize and pay their debts through a plan approved by the Court.

I. Chapter 15 relates to proceedings related to a foreign insolvency proceeding where the foreign entities have assets in the United States or there are other connections to the United States

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II. The Players

A. Always with leading roles

1. The Debtor

The debtor is the entity seeking relief under the Bankruptcy Code. Unlike in Chapter 7, 12, or 13 cases, a trustee is not automatically appointed in a chapter 11, instead the debtor typically continues to operate its business as it did prior to the filing of the bankruptcy case, thus giving rise to the moniker, "debtor-in-possession." With certain limited exceptions, Section 1107(a) of the Bankruptcy Code gives a debtor-in-possession "all the rights, . . . and powers" as well as "all the functions and duties, . . . of a trustee . . ." Generally, a person or organization that files a bankruptcy petition transforms into a "new" entity which has the power (a) of a bona fide purchaser (regardless of any actual knowledge of the debtor), (b) of a judicial lien creditor (even if none exist), and (c) to recover monies paid or property transferred within certain periods. This transformation is at the heart of a reorganization—and it can be a very frustrating experience for a creditor.

2. The United States Trustee

The United States Trustee (not to be confused with a "trustee") is an officer of the United States Department of Justice responsible for monitoring bankruptcy cases. The United States Trustee is responsible for appointing creditor committees, Chapter 7 Trustees, Chapter 13 trustees and, if so ordered by the bankruptcy court, Chapter 11 Trustees. The United States Trustee has the right to be heard on any matter coming before the bankruptcy court and to file motions with court in furtherance of its duties.

B. Usually have a leading role

1. Secured Creditors

Secured creditors are creditors whose claim is backed by collateral. Often times, secured creditors have the largest stake in the outcome of a bankruptcy case.

2. The Creditors Committee

The Bankruptcy Code provides for the appointment of an "official" committee to represent the interests of unsecured creditors under Chapter 7 and Chapter 11. In a Chapter 7, there often is little distribution to unsecured creditors and thus no need for an unsecured creditors' committee. In a Chapter 11, however, a creditors' committee often plays an important role. In a Chapter 11, a creditors' committee may:

(a) Consult with the trustee or the debtor-in-possession concerning the administration of the case;

(b) Investigate the conduct and financial affairs of the debtor, investigate the operation of the debtor's business, and determine the desirability of continued operations;

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(c) Participate in the formulation of a plan of reorganization and make recommendations concerning the plan; and

(d) Request the appointment of a trustee or examiner if circumstances warrant it.

In some Chapter 11 cases, there may be multiple creditors committees and, if it appears there may be return for equity, an equity committee.

C. Sometimes have roles

1. A Trustee

In all cases under Chapter 7, Chapter 12 and Chapter 13, a trustee is appointed to administer the property of the estate according to the provisions of the particular chapter under which relief has been ordered. A trustee is appointed in a Chapter 11 case only on the request of a party-in-interest and after notice and hearing by the court. If a trustee is appointed, a new party is added to all pending litigation. A trustee may seek appointment of its own counsel who may not be the counsel who previously represented the debtor in the pending litigation. All pending causes of action “belong” to the trustee. This is extremely important in the context of settling litigation. The duties of the trustee vary depending on the chapter of the Bankruptcy Code under which relief has been ordered.

2. An Examiner

In a chapter 11 case, the Court may consider the appointment of a Trustee as too extreme and instead appoint an examiner. An examiner may be appointed to conduct an investigation into any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor. This examination may include both pre-petition and post-petition actions of the debtor.

3. Ad Hoc Committees

In addition to the creditors committee appointed by the U.S. Trustee, other groups of creditors may agree to have their mutual interests represented during a bankruptcy case. An ad hoc committee is an unofficial committee that represents only the interests of its members versus the general representation of all unsecured creditors undertaken by the Creditors Committee. The professionals employed by an ad hoc committee are paid by the members of the ad hoc committee; although they may seek reimbursement of such costs to the extent the ad hoc committee makes a substantial contribution to the case. The ad hoc committee will need to submit a verified statement under Rule 2019 indicating:

(a) the name and address of the creditor or equity security holder;

(b) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition;

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(c) a recital of the pertinent facts and circumstances in connection with the employment of the entity, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and

(d) with reference to the time of the employment of the entity, the organization or formation of the committee, the amounts of claims or interests owned by the entity, the members of the committee, the times when acquired, the amounts paid to acquire the claim or interest, and any sales or other disposition thereof.

The statement shall include a copy of the instrument, if any, whereby the committee is empowered to act on behalf of creditors or equity security holders. The failure of an ad hoc committee to meet these requirements may prevent them from participating in the bankruptcy case.

III. The Venue

Bankruptcy courts fall under the jurisdiction of the United States District Courts. Bankruptcy courts are divided into the same districts as United States District Courts within a particular state; however, the divisions may not be the same. As one would expect, each district and each judge within a division will have varying requirements and particularities. No decision of a district judge or a fellow bankruptcy judge is binding on a bankruptcy judge; judges within a district often disagree on key issues.

IV. The Estate

The commencement of a bankruptcy case creates an estate comprised of all legal or equitable interests of the debtor in property wherever located. Property recovered pursuant to certain sections of the Bankruptcy Code also becomes property of the estate.

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THE AUTOMATIC STAY

I. Imposition of the Stay

The automatic stay is an integral part of the Bankruptcy Code. The automatic stay prevents a chaotic and uncontrolled scramble for a debtor's assets by creditors. The purpose of the stay is to preserve the status quo.

The automatic stay protects debtors because it gives the debtor a breathing spell from creditors. It stops all collection efforts, all harassment and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan or simply to be relieved of the financial pressures that drove him into bankruptcy. The automatic stay also provides creditors with protection, because without it other creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally.

The effect of the automatic stay on pending litigation is often confusing. The first step is to determine the original posture of the pre-petition action – if the action was commenced against the debtor, as a general rule, it is stayed regardless of its current posture. If the debtor is the plaintiff and if there are no counterclaims seeking affirmative relief, the pre-petition action is not stayed. State and federal courts have concurrent jurisdiction to decide the effect of the stay. The automatic stay does not bar a party from commencing an adversary or contested proceeding against the debtor in the bankruptcy court.

The majority of courts have held that violations of the stay are void *ab initio.* This can be a significant distinction for litigation. However, in *Picco v. Global Marine Drilling Co.,* 900 F.2d 846 (5th Cir. 1990), the Court of Appeals for the Fifth Circuit held that an action commenced during the pendency of the automatic stay was voidable, not void—clearly a minority position. Some courts have found a middle ground by holding that an order lifting the stay can be entered *nunc pro tunc* (i.e., retroactively).

Unless the debtor files a petition under Chapter 12 or Chapter 13, a creditor is not automatically stayed from pursuing its claims against co-debtors, including guarantors, affiliates or subsidiaries. The filing by a partner does not stay foreclosure on real estate belonging to the partnership.

II. Relief from the Stay

The Bankruptcy Code, pursuant to Section 362(d), and the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"), pursuant to Bankruptcy Rule 4001, create a procedure for creditors to seek relief from the stay. A creditor need not be secured to seek relief from the stay.

Upon the request of a party-in-interest and after notice and hearing, the court shall grant relief from the stay:

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(a) For cause, including lack of adequate protection of an interest in property of such party in interest;

(b) With respect to a stay of an act against real or personal property of the debtor, if the debtor does not have any equity in such property and such property is not necessary to an effective reorganization.

For example, it may be possible and advisable for a plaintiff in a pre-petition action to seek modification of the automatic stay to permit litigation to proceed, particularly if the pending litigation is very near trial and the judge in the pending litigation is already familiar with the factual and legal principles of the case or has disposed of several preliminary matters.

Note also that there are now special provisions of section 362 of the Bankruptcy Code addressing stay and relief from stay matters involving single asset real estate debtors and debtors with repeat bankruptcy filings. Those provisions were added to prevent perceived problems and abuses of the bankruptcy system.

III. Hearing on Relief from Stay

The court must hold a preliminary hearing within thirty (30) days of the filing of such a motion. Some courts treat the first hearing as a preliminary hearing, but a final hearing must be commenced within thirty (30) days of any preliminary hearing, unless the movant consents to an extension. The stay may terminate if the debtor fails to request a timely hearing, the court fails to schedule a hearing, the court adjourns a scheduled hearing on its own motion, or the court holds a hearing but issues no order of continuance within the thirty-day period. Actual trial procedures vary in each court.

The party requesting relief from the automatic stay has the burden of proof on the issue of the debtor's equity in property, while the party opposing relief from stay has the burden on all other issues. However, the moving party must first establish a *prima facie* case in support of its request for relief from the automatic stay.

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THE CLAIMS PROCESS

I. Types of Claims

Under the Bankruptcy Code, each class of claims must be treated in a fair, equitable and nondiscriminatory manner. By law, certain classes of claims are entitled to preferred treatment. In general, unless classes with a higher priority are paid in full or agree to accept less than full payment, no junior class of creditors is entitled to receive any payment.

A. Secured

A claim is secured to the extent of the value of such creditor's interest in the estate's interest in such property, if a creditor holds a perfected lien on property of the estate or if a creditor has a claim that is subject to setoff under section 553 of the Bankruptcy Code. If the value of the collateral exceeds the amount of the claim, the creditor is entitled to claim post-petition interest and any reasonable fees and expenses provided by the agreement under which the claim arose. Any debt in excess of the value of the collateral will be treated as an unsecured claim.

B. Unsecured

Claims that are not secured by a lien on property of the estate are treated as unsecured claims even if secured by assets not owned by the debtor. Deficiency claims are also treated as unsecured claims.

C. Priority

Under section 507 of the Bankruptcy Code, certain unsecured creditors may be entitled to receive payment of their claims prior to any payments being made to other general unsecured creditors. Typically, claims held by governmental entities are entitled to receive priority treatment. Additionally, the debtor's employees are entitled to priority treatment of any unpaid wages and/or benefits earned during the 180 days prior to the commencement date of the bankruptcy case, up to $11,725. Customers who are individual consumers that have placed deposits for the purchase of goods from the debtor may also be entitled to a priority claim for recovery of their deposit up to $2,600.

D. Administrative

Section 503 deals with the allowance of administrative expense claims. Generally, administrative expense claims arise out of any transaction with the debtor that has occurred post-petition. This could include services provided by professionals of the estate, including the debtor's attorneys and financial advisors, the attorneys and financial advisors of the official creditors' committee or any other committee appointed by the court, and the fees and expenses of a trustee or examiner. Additionally, to the extent a creditor provides a substantial contribution to the estate, such creditor may seek recovery of any fees and expenses incurred in connection with those efforts. Courts have also found that post-

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petition torts committed by the debtor may constitute an administrative expense of the estate.

The recent amendments to the Bankruptcy Code have also created an additional group of creditors that may be entitled an administrative expense claim. Any party that provided goods to the debtor within the twenty (20) days prior to the commencement of the bankruptcy case may seek payment for those goods as an administrative expense claim under section 503(b)(9) of the Bankruptcy Code. This administrative expense claim is for the value of goods that were used by the debtor in the ordinary course of its business and does not include any amounts owed by the debtor for services that may have been provided to the debtor during that time period.

E. Equity

To the extent the debtor is able to pay its debts in full, the equity holders of the debtor may be entitled to recover some value for their interests. In the case of a reorganization, a plan may provide that equity retain its interest in the debtor, but only if the plan provides for payment of all creditors in full or the creditors agree to some other type of treatment.

II. Filing a Claim

In every case, the debtor must file schedules listing all of the debtor's assets and liabilities and a statement of financial affairs. A creditor of the debtor should check the debtor's schedules of assets and liabilities filed in the bankruptcy case to see if the creditor's claim is listed. In reviewing the schedules, the creditor should take note of the following:

- Is the claim listed as "CUD"—which means that the claim is contingent, unliquidated and/or disputed?
- Is the amount of the claim incorrect?
- Is the status incorrect (secured or unsecured)?
- Is it a Chapter 7 case?

If the answer to any of these questions is "yes," a proof of claim must be filed in order to receive a recovery from the estate. Creditors should note that a "Bar Date" will be set and any claims not filed by such date will be disallowed unless the creditor can show that "excusable neglect" was the reason for the late claim.

Filing a proof of claim generally constitutes submission to the jurisdiction of the bankruptcy court and potentially a waiver of the right to a jury trial in later litigation. *See Langenkamp v. Culp,* 498 U.S. 42 (1990) (holding that when a party files a claim it loses its 7th Amendment right to a jury trial on a preference action and submits itself to the equitable jurisdiction of the bankruptcy court); *Granfinanciera, S.A.. v. Nordberg,* 492 U.S. 33 (1989) (holding that if no proof of claim is filed, a preference is a legal action in which defendant is entitled to a jury trial). While it is not necessary to file a proof of claim in a Chapter 11 case if the claim is properly scheduled and is not listed as disputed, contingent or unliquidated, it is generally

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good practice to file a proof of claim in order to provide documentation supporting the claim if there is no concern regarding jurisdiction and/or jury trials. If the Chapter 11 case is later converted to a Chapter 7 and no proof of claim was filed, a proof of claim must be filed.

Depending upon the size of the case, the debtor may serve a bar-coded proof of claim form or have a form available for use on a designated website. These website forms are often helpful because the forms may already include important information relating to the case.

III. Allowed Claims

Any party holding a claim or interest against the debtor may establish the nature and extent of the claim or interest by filing a proof of claim. A proof of claim may be filed even if the claim is unliquidated or contingent. Often, if a party is involved in litigation against a debtor, filing the proof of claim may eliminate the need for further litigation. A claim or interest is deemed allowed as filed, unless a party-in-interest objects.

IV. Claim Objections

Absent an objection, claims that are filed are presumed valid and generally deemed allowed. Bankruptcy Rule 3007 requires that an objection to a claim must be in writing. Additionally, if the objection is joined with a demand for relief of the kind specified in Bankruptcy Rule 7001, including, *inter alia*, an attempt by the debtor to recover funds from the claimant or a challenge to the creditor's lien, then it must be filed as an adversary proceeding. In essence, an adversary proceeding is a lawsuit and many (but not all) of the Federal Rules of Civil Procedure apply.

There are certain statutory grounds contained in the Bankruptcy Code mandating disallowance of a claim. Pursuant to section 502(b) of the Bankruptcy Code a claim will be disallowed if it is:

(a) Unenforceable;

(b) For unmatured interest;

(c) For a debt that is unmatured on the date of filing of the petition and that is not subject to a discharge;

(d) For damages to a lessor resulting from the termination of a lease of real property, and the damages exceed the rent for one (1) year or fifteen percent (15%) of the remaining term of the lease; or

(e) For damages resulting from the termination of an employment contract which exceed the compensation for a one (1) year period under the contract.

V. Limitation Periods for Claims Against the Debtor

Section 108(c) of the Bankruptcy Code provides a set of rules that govern the effect of limitations periods. If applicable nonbankruptcy law, an order entered in a nonbankruptcy

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proceeding, or an agreement fixes the period of time for commencing or continuing a civil action in a court on a claim against the debtor, and such period has not expired before the date of the filing of the petition, then such period does not expire until the later of:

(a) The end of such period, including any suspension of such period occurring on or after the commencement of the case; or

(b) 30 days after notice of the termination or expiration of the stay with respect to such claim.

In general, any party that was stayed from commencing or continuing a legal proceeding because of a bankruptcy filing has at least thirty (30) days after deemed notice that the stay has terminated to recommence such action.

VI. Setoff

The nature, existence and enforceability of setoff are determined by applicable state law. When (or even if) setoff may occur is a matter of federal law. If the right to setoff exists under state law, then the only additional element is that the claims must be of the same character. In other words, they must be mutual and arise pre-petition.

The issue of the right of setoff typically arises when the debtor seeks to compel payment or turnover of property from a creditor. Setoff may not be exercised without approval of the Bankruptcy Court. The burden of proof appears to lie with the creditor claiming the right of setoff. Setoff may be permissible even if one of the debts is absolutely owing but not due or the liability is unliquidated. A pre-petition contingent claim may be offset against a debtor's pre-petition claim. A debt is a "mutual debt" if it is between the exact same parties in the same right or capacity. A subsidiary may not setoff a debt owed to a debtor against a debt owing from the bankrupt to another subsidiary. A parent corporation may not offset a debt owed to a debtor against a debt owing from the debtor to a wholly-owned subsidiary.

VII. Recoupment

The Bankruptcy Code is silent on the remedy of recoupment. If a debtor and creditor have claims against each other arising from the same contract or transaction, the right of recoupment may arise. There is no requirement that both be pre-petition. For example, if the creditor made a pre-petition overpayment in connection with a specified transaction, it may assert a post-petition right of recoupment against any amounts owed to the debtor. Recoupment may be exercised unilaterally. There does not have to be any express contractual right to withhold payments in order to recoup—but it doesn't hurt. A failure to file a proof of claim or otherwise exercise a right of recoupment can result in a waiver.

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LITIGATION INVOLVING THE DEBTOR

I. Limitation Periods for Claims Asserted by the Debtor after the Petition Date

Section 108(a) of the Bankruptcy Code applies to commencement of causes of action belonging to a debtor or a trustee. If applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes the period of time within which the debtor may commence an action, and such period has not expired before the date of the filing of the petition, the trustee may commence such action only before the later of:

(a) The end of such period, including any suspension of such period occurring on or after the commencement of the case; or

(b) Two years after the order for relief.

II. Limitation Periods for Pre-Petition Actions by the Debtor

Section 108(b) of the Bankruptcy Code applies to actions that were commenced pre-petition. If an order entered in a nonbankruptcy proceeding or an agreement fixes a period within which the debtor may file any pleading, demand, notice, or proof of claim or loss, cure a default, or perform any other similar act, and such period has not expired before the date of the filing of the petition, the trustee may only file, cure or perform, as the case may be, before the later of:

(a) The end of such period, including any suspension of such period occurring on or after the commencement of the case; or

(b) 60 days after the order for relief.

III. Removal

After the commencement of the Bankruptcy Case, any party to a lawsuit may seek to remove such lawsuit for consideration by the Bankruptcy Court. Under 28 U.S.C. § 1452(a), any party (plaintiff or defendant) may remove any claim or cause of action in a civil action to the district court for the district where such civil action is pending. It is important to remember that a case is removed to the United States District Court where the action is pending—not where the bankruptcy is pending. Following removal, the party can seek a change of venue to the United States District Court where the Bankruptcy Case is pending, and the litigation should then be referred to the Bankruptcy Court. Rule 9027 of the Bankruptcy Rules provides the procedures for removal and remand.

A. Pre-Petition Action

If an action was pending when the bankruptcy petition was filed, Bankruptcy Rule 9027(a)(2) provides that an application for removal may be filed within the longest of:

(a) 90 days after the order for relief in the case under the Bankruptcy Code;

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(b) 30 days after entry of an order terminating the stay, if the claim or cause of action in a civil action has been stayed under section 362 of the Bankruptcy Code; or

(c) 30 days after a trustee qualifies in a Chapter 11 reorganization case but no later than 180 days after the order for relief.

B. Post-Petition Action

If an action is commenced after the filing of the bankruptcy petition, Bankruptcy Rule 9027(a)(3) provides that an application for removal may be filed only within the shorter of:

(a) 30 days after receipt, through service or otherwise, of a copy of the initial pleading setting forth the claim or cause of action sought to be removed; or

(b) 30 days after receipt of the summons if the initial pleading has been filed but not served with the summons.

IV. Remand

If a lawsuit is removed, any party to the lawsuit may seek to have the lawsuit remanded to the court that was previously considering the matter. Under 28 U.S.C. § 1452(b), the court to which such claim or cause of action is removed may remand such claim or cause of action on any equitable ground. An order entered remanding a claim or cause of action, or a decision to not remand, is not reviewable by appeal or otherwise. In determining whether to remand a case, factors the courts will consider include:

(a) the effect or lack thereof on the efficient administration of the estate;

(b) the extent to which state law issues predominate over bankruptcy issues;

(c) difficult or unsettled nature of applicable law;

(d) the presence of related proceedings commenced in state court or another nonbankruptcy proceeding;

(e) the degree of relatedness or remoteness of proceeding to the main bankruptcy case;

(f) the substance rather than the form of an asserted core proceeding;

(g) the feasibility of severing state law claims from core bankruptcy matters to allow judgments to be entered in the state court with enforcement left to the bankruptcy court;

(h) the burden on the bankruptcy court's docket;

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(i) the likelihood that the commencement of the proceeding in the bankruptcy court involves forum shopping by one of the parties;

(j) the existence of a right to a jury trial;

(k) the presence in the proceeding of non-debtor parties;

(l) comity; and

(m) the possibility of prejudice to other parties in the action.

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ACQUISITIONS/SALES IN BANKRUPTCY

I. Section 363 Sales

Section 363(c)(1) of the Bankruptcy Code authorizes a trustee or debtor-in-possession to enter into transactions, including the sale of property of the estate, in the ordinary course of business, without notice or a hearing. Section 363(b)(1) allows the trustee or debtor-in-possession to use, sell or lease, other than in the ordinary course of business, property of the estate after notice and a hearing. Bankruptcy Rule 6004 addresses the procedures for (i) notice (requiring 20 days notice unless shortened by the Court); (ii) objections to the sale; (iii) the possible ways to conduct the sale (*i.e.* public auction or private sale); and (iv) execution of the necessary documents to consummate the sale.

Section 363 sales have leapt to the forefront in bankruptcy practice because of the speed in which they can be effectuated and because, in certain circumstances, the Bankruptcy Code allows the debtor to sell property of the estate free and clear of any interest in the property. Most court decisions have adopted the "Delaware approach" pursuant to which the courts require that a sale comport with four requirements. These requirements are that:

A. Sound business purposes exist for the sale

The "sound business purpose test," requires a determination that the evidence supports a "good business reason" to approve the sale. Generally the following factors should be taken into account:

(1) The proportionate value of the asset to the estate as a whole;

(2) The amount of elapsed time since the filing;

(3) The likelihood that a plan will be proposed and confirmed;

(4) The effect of the proposed distribution on future plans;

(5) The proceeds to be received from the sale versus appraisals or evaluations of the property; and

(6) Whether the asset is increasing or decreasing in value.

B. The sale price is fair

C. Reasonable and adequate notice

In order for the debtor to provide adequate and reasonable notice, the notice should:

(1) Place all parties on notice that the debtor is liquidating its business.

(2) Disclose accurately the full terms of the sale.

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(3) Explain the effect of the sale (e.g., does it terminate the debtor's ability to continue in business).

(4) Explain why the proposed price is reasonable.

(5) Explain why the sale is in the best interest of the estate.

D. The purchaser is acting in good faith.

In order to conduct a sale free and clear the debtor must demonstrate that the sale meets one of the following factors:

(a) Applicable non-bankruptcy law permits sale of such property free and clear of such interest (section 363(f)(1));

(b) Entities holding such interest consent to the sale of assets free and clear of any liens (section 363(f)(2));

(c) Such interest is a lien, and the price at which the property is to be sold is in excess of the liens against the property (section 363(f)(3));

(d) A bona fide dispute exists as to the validity of the claimant's asserted interest in the property to be sold (section 363(f)(4)); or

(e) The entity asserting an interest in the property could be compelled to accept a money satisfaction of its interest (section 363(f)(5)).

In regards to receiving the consent of the entity holding an interest, consent may be implied. The key to the validity of implied consent appears to be the quality of the notice, which involves three separate issues: (1) the reasonableness of efforts to assure actual receipt of notice; (2) the information contained in the notice; and (3) the amount of time afforded to respond. Reasonable effort to ensure receipt of actual notice is required, such as overnight, e-mail, certified mail, facsimile or messenger delivery. Publication notice is less effective but might be all that is available in certain circumstances. The contents of any notice should be clear with regard to the proposed treatment of the interest so that failure to object unambiguously implies consent.

Where the amount of debt is in dispute, resolution of that dispute is unnecessary to approve sales in jurisdictions that permits sales under section 363(f)(3) for less than the debt secured by the collateral. However, some jurisdictions require that the sale price of the collateral exceed the secured debt, and there application of section 363(f)(3) may require resolving the disputed amount of debt in order to ensure that the proposed sale price exceeds the debt secured by the collateral.

Section 363(f)(5) permits sales free of an interest of an entity that could be compelled in a legal or equitable proceeding to accept money satisfaction of its interest. “Money satisfaction” means cash money and not merely a promise or obligation to pay.

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Numerous courts have held that section 363(f)(5) applies wherever a secured creditor's interest can be crammed down under a plan. But some courts have rejected the interpretation that section 363(f)(5) can be invoked whenever the debtor hypothetically could confirm a cram-down plan. At least two courts have held that section 363(f)(5) cannot be invoked in a liquidation case to require a secured creditor to accept less than full satisfaction, and other cases have simply rejected outright the availability of a hypothetical cram-down as a test for section 363(f)(5).

Read broadly, the statute would allow sales free of such common encumbrances as mortgages, tax liens and mechanic's liens because the law in every jurisdiction provides that such liens must be released if full satisfaction is tendered. Under this analysis, it would not be necessary for the proposed bankruptcy sale to actually produce a full satisfaction, but only that—hypothetically—the interest could be forced to be released if a full money satisfaction were rendered.

The most recent decisions at the Court of Appeals level have held that a sale can be free and clear of claims as long as the claims are connected to or arise from the property being sold and would under normal circumstances follow the property when sold. *In re Trans World Airlines, Inc.,* 322 F.3d 283, 290-91 (3d Cir. 2003) (agreed with by *Cibulka v. Trans World Airlines, Inc.,* 92 Fed. Appx. 366, 368 (8th Cir. 2004). These decisions followed the precedent of *In re Leckie Smokeless Coal Co.,* 99 F.3d 573 (4th Cir. 1996), which held that, although not all general rights to payment are within the scope of section 363(f), property can be sold free of claims amounting to successor liability if they are somehow connected to the property. *See id.* at 581-82. *See also In re Medical Software Solutions,* 286 B.R. 431, 446-47 (Bankr. D. Utah 2002) (approving the sale of assets free and clear of successor liability claims). In recent cases, "interest" has been expanded to include adverse possession claims, personal injury claims, licenses to use intellectual property and a lessee's possessory interest.

The use of section 363(f) to free purchasers from successor liability claims has not been uniformly accepted, and the proposition remains subject to doubt. Moreover, the debate continues over whether future claims—such as product liability claims not yet manifested by injury—can be kept from flowing with the property to the purchaser. Nevertheless, debtors—in their efforts to liquidate assets for the best price—and purchasers—in their understandable desire to buy assets, not liabilities—will continue to push for the expansion of the kinds of "interests" that bankruptcy sales can detach from property.

II. Practice and Procedure for Section 363 Sales

The purchase of assets under section 363 involves both in- and out-of-court activity. The hearings to approve sale procedures and/or the actual hearing to approve the sale itself are only the tip of the iceberg.

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A. Out of Court Activity

1. Identification of Assets

The real fun takes place in offices, conference rooms, lobbies, bars and courthouse halls across the country. The first and obvious issue to address in connection with a section 363 sale is for the debtor (or the debtor in consultation with other constituents such as secured creditors and the creditors' committee) to identify assets to be sold. There are often disputes among the various constituencies regarding what assets to market and how best to market those assets. Skillful negotiation is often necessary to convince recalcitrant constituents that a sale should be attempted. Parties should also understand how the potential sale will impact the debtor's ongoing business, if the sale is of less than all of the debtor's assets.

In some instances, a sale might be obvious when it relates to unused and excess equipment, unused buildings and/or real property, under-performing divisions or product lines, operations in a geographic or business section which the debtor wishes to exit, or all assets when the debtor is clearly failing. All sales, however, will have common issues that need to be addressed, including:

- Are the assets readily sellable?
- What are the time pressures/constraints?
- What action is necessary to properly prepare the assets for sale?
- What are the costs (particularly holding costs) with respect to such assets?
- What length of time do the assets need to be exposed to the market?
- Have offers previously been made for the assets?
- Are the assets readily transferable or are there significant practical or legal hurdles to overcome?
- Do the assets have value compared with holding costs and costs of sale?
- What effect will a sale have on the continuing operations of the debtor?
- Will the assets have to be replaced?
- If there are a number of assets to be sold, what is the best mechanism to maximize value for all assets?
- Can certain assets be "sold" multiple times (*i.e.* software and other intellectual property)?

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2. Due Diligence

Depending upon the assets being sold, due diligence can be as simple as an inspection of the assets and providing appraisals or other documentation, or as complex as a full blown, in-depth analysis of the entire company's operations.

Practical steps include establishment of a “due diligence” package or data room (commonly a “virtual data room”), determining who has access, and addressing confidentiality concerns. The adequacy of the diligence information often arises where a potential bidder argues they were “frozen” out of the sale process because they where denied sufficient access to information to bid.

3. Negotiations with Potential Purchasers

Either after or during the due diligence period, the debtor, secured creditors and/or the committee often are negotiating the terms of the proposed offer with potential purchasers. The aim is to negotiate a letter of intent or other written offer and possibly select a “stalking horse.”

In some circumstances, the asset purchase agreement can be negotiated at this stage, either with a proposed purchaser or for use as a form for bidding by potential purchasers. It is at this stage, and hopefully before submitting the purchase proposal to the court, that approval and support of necessary constituencies in the case is obtained. Obviously, a consensual transaction is preferred.

4. Preparation of the Section 363 Motion

Once the process is finalized, the parties prepare the section 363 motion. Issues at this stage include timing of filing of the motion, extent of notice, and the length of the notice period. Also, serious disputes may arise over whether an auction or other bid process is necessary, how long such process should take, the extent and type of bid protections to be granted, and the like. Usually the debtor and (if one has been identified) the potential purchaser—with input from secured creditors, the creditors' committee and other interested constituents—will try to reach an agreement on these issues prior to filing the motion.

B. In Court Activity

1. Bid Procedures Hearing

One aspect of the section 363 process is court approval of bidding and, potentially, bid protection procedures. Such protections can include:

(a) Break-up fees;

(b) Topping fees;

(c) Expense reimbursements; and

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(d) Limitation of the debtor's solicitation of competing bids, such as (i) requiring potential competing bidders to submit bids by specific dates and in form similar to or the same as that of the stalking horse, (ii) establishing over-bid increments, and/or (iii) requiring qualification of bidders.

Some courts will refuse to approve a break-up fee or other forms of bid protections if it appears there are already one or more potential purchasers. A non-stalking horse potential purchaser may find it advantageous to eliminate any break-up fee.

The interested parties will also try to agree upon how an auction will be conducted in connection with the proposed sale. The bid procedures may also include provisions requiring minimum incremental bid amounts, requirements that bids exceed the highest bid by a certain percentage and/or provisions allowing the stalking horse bidder the right to match qualifying bids. The court may also establish procedures regarding notices of the final sale hearing, the efforts which must be undertaken to solicit other and further bids, the criteria the court will use in determining which bid might be considered the highest and best bid, and similar matters.

The Bid Procedures Order will also usually specify the date, time and place of any auction and the type of auction (in-court, out-of-court, sealed-bid and/or open-cry) in the event qualified competing bids are submitted prior to the final hearing on the sale. Some courts prefer that the auction take place in the presence of the court while others require the auction take place outside of the courtroom with only the highest and best bidder(s) submitted to the court for approval at the conclusion of the auction. Procedures sometimes provide, after bidding has proceeded to a certain point, that the bidders submit a sealed highest and last best bid.

2. Sale Procedures

At the sale hearing, the court will consider whether the sale of assets under section 363 is in the best interest of the creditors and the estates. The court will also determine if the sales price represents the highest and best offer for the assets.

The multistep process may not take place in all circumstances. In some section 363 sales, no bid-procedure hearing occurs and there is simply an auction immediately before or as part of the final sale hearing. In these instances, there is little procedural protection for the potential purchasers.

Competing bidders generally do not have standing before the bankruptcy court to object to the procedures for a section 363 sale. The court ordinarily will not focus on fairness to a competing bidder; instead it will focus on establishing procedures that will produce the best return to the debtor. The rationale is that competing bidders are strangers to the bankruptcy case and that only real parties-in-interest, (generally the creditors and the debtor), have standing to establish or dispute the procedures. Generally, a competing bidder should not bid if it is unsatisfied with the procedures. It is unlikely a bankruptcy court would overturn procedures supported by the debtor and major creditors—even where competitive bidders feel aggrieved—if the return to the estate seems appropriate.

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C. Differences from Traditional Mergers & Acquisitions

A purchase agreement in the section 363 context differs markedly from a non-bankruptcy purchase agreement. When a sale is conducted under section 363, the debtor is typically insolvent, so little protection by way of representations, warranties and indemnification exists. Sales are usually "as is," "where is." Furthermore, hold-backs and escrows typically are more difficult to negotiate, as creditors will demand a known net purchase price. Forum selection issues generally do not arise as the bankruptcy court will continue to exercise jurisdiction over the transaction but any unique forum selection issues should be subject to court approval. Additionally, pending bankruptcy court approval, purchasers may be bound to the terms of the purchase agreement though the debtor is not.

A potential purchaser should include the following provisions in the purchase agreement:

(1) Strict deadlines for the filing of motions to approve the bid procedures and for approval of the sale. Deadlines for the entry of orders approving bid procedures or the sale are also common.

(2) Provisions concerning expense reimbursement or break-up fees must address priority issues, *e.g.,* will payment of the purchaser's expense reimbursement or break-up fee prime the senior lenders or other administrative claims.

(3) The assumption and assignment of contracts and leases, and also address how all defaults will be cured and who will bear the "cure costs."

(4) A purchaser should always obtain a finding from the bankruptcy court that it is a good faith purchaser.

(5) Effectiveness of the purchase agreement should be conditioned on the entry of an order approving the sale in form and substance satisfactory to the purchaser.

D. Consumer Data

Revised section 363(b)(1) exemplifies the "consumer protection" undercurrent of the new bankruptcy reforms by adding special procedural requirements for conducting sales of "personally identifiable" consumer information. Inevitably, the section 363 sale process will have a new player to contend with when consumer data is involved. Although these revisions will affect only a fraction of section 363 sales, they will nevertheless have a measurable impact in cases with any connection to consumer retailing.

If the debtor has disclosed to an individual a "policy prohibiting the transfer of personally identifiable information [to unaffiliated third parties]," the sale cannot be approved unless either (1) the transfer of the data is deemed consistent with the disclosed policy, or (2) the court finds that, after appointment of a "consumer privacy ombudsman" under new

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section 332 of the Bankruptcy Code, the sale would not "violate applicable non-bankruptcy law."

Under section 332, the U.S. Trustee is empowered to appoint a consumer privacy ombudsman in advance of a section 363(b) hearing involving the transfer of personally identifiable information. The ombudsman essentially acts as a class representative for potentially affected consumers. The Bankruptcy Code defines "personally identifiable information" to include a broad range of consumer personal data, including names, addresses, Social Security Numbers and credit card account numbers.

E. Regulatory Issues

The potential purchaser will also need to obtain any necessary regulatory approvals. Such approvals make include any necessary Hart-Scott-Rodino antitrust clearance if the purchase price might exceed $50 million. In such cases, the Bankruptcy Code shortens the 30-day initial review period to 10 days.

F. Executory Contracts and Leases

Section 365 of the Bankruptcy Code allows a purchaser to assume most leases and contracts, which may be included as a part of a sale of the debtor's assets. To assume and assign contracts and leases, however, defaults must be cured (often out of the purchase price) and the purchaser must be prepared to provide "adequate assurance of future performance." Generally, a purchaser can meet this test if it is in the same or better financial condition as the debtor was at the time the debtor executed the contract or lease. Obviously, the best practice is to resolve such issues with the other party to the agreement before closing. Under the recent amendments to the Bankruptcy Code, negotiations can be particularly critical when dealing with the assumption or rejection of real property leases and contracts.

G. Finality

Under Bankruptcy Rule 6004, the beneficiary of a sale order generally cannot act upon that order for fourteen (14) days, but the rule also grants (and the courts often exercise), discretion to shorten this period of time. A purchaser may need to close a transaction immediately upon the entry of an order approving the section 363 sale.

Section 363(m) of the Bankruptcy Code provides that a good faith purchaser cannot have a transaction unwound on appeal even if the appellant obtains a reversal of the order approving the section 363 sale. In the event (i) an appeal is filed, (ii) the appellant does not obtain a stay of the section 363 sale approval order, and (iii) the sale closes, a substantial body of case law holds that an appeal should be dismissed as moot because the appellate court cannot unwind the transaction, and it would be a waste of appellate court resources to consider an appeal on which no relief can be granted.

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H. Sales Immediately Following the Commencement of the Case

Under recent amendments to the Bankruptcy Rules, Rule 6003 now provides that, except to the extent that relief is necessary to "avoid immediate and irreparable harm", the bankruptcy court shall not within 21 days after the filing of the petition grant relief providing for the use, sale or lease of property of the estate or the incurring of an obligation regarding property of the estate. In practice, this has made it somewhat more difficult to accomplish an immediate pre-bankruptcy negotiated sale of all of a debtor's assets (which was a common practice in some courts) but true emergency sales can still be approved with the right factual showing of the need for immediate relief.

OTHER COMMON ISSUES ARISING IN THE BANKRUPTCY CASE

I. Real Estate Issues

A. Assumption or Rejection

While the debtor is given the opportunity to assume or reject leases, it is important to recognize that assumption or rejection of the lease must be made with respect to the entire agreement. *See In re Audra-John Corp.*, 140 B.R. 752 (Bankr. D. Minn. 1992) (citing cases). Partial assumptions or assumptions of select provisions of a lease are not authorized, and the trustee or debtor-in-possession assumes or rejects unexpired agreements in their entirety. *Century Indem. Co. v. NGC Settlement Trust (In re National Gypsum Co.)*, 208 F.3d 498, 506 (5th Cir. 2000). In this context, it is often stated that the trustee or debtor-in-possession has to assume the agreement or reject the agreement in its entirety, with both its benefits and its burdens. *See, e.g.*, *City of Covington v. Covington Landing L.P.*, 71 F.3d 1221 (6th Cir. 1995). On the other hand, if the agreement contains separate, severable agreements, the debtor may reject some, but not others; rejection does not require rescission of executed portions. *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735 (5th Cir. 1996); *In re Adelphia Bus. Solutions, Inc.*, 322 B.R. 51(Bankr. S.D.N.Y. 2005) (citing numerous cases).

B. Debtor as Lessee

1. Ipso Facto Clauses

One issue that often arises when a party files bankruptcy is that the landlord, upon reviewing its contract or lease, desires to enforce an *ipso facto* provision to the effect that the contract or lease is automatically terminated, if the other party files bankruptcy. Such provisions are unenforceable under section 365(e)(1) of the Bankruptcy Code.

2. Pre-Petition Termination

Section 365(e)(1) does not serve as a basis for revival of a lease terminated prior to the bankruptcy filing. *See, e.g.*, *Comp III, Inc. v. Computerland Corp.*, 136 B.R. 636 (Bankr. S.D.N.Y. 1992). As noted by another court, where the debtor breached a contract and the

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contract was actually terminated as a result of the breach, the termination is valid. *Nemko, Inc. v. Motorola, Inc., (In re Nemko, Inc.)*, 163 B.R. 927 (Bankr. E.D.N.Y. 1994).

3. Shopping Center Leases

In connection with the assumption (or the assumption and assignment) of a lease in a "shopping center," Congress has provided special protections to landlords and other tenants. *Trak Auto Corp. v. West Town Ctr. LLC (In re Trak Auto Corp.)*, 367 F.3d 237 (4th Cir. 2004). *See also In re Compuadd Corp.*, 166 B.R. 862 (Bankr. W.D. Tex. 1994). In order to assume a lease of real property in a shopping center, certain requirements must be met. The financial standing of the proposed assignee must be similar to that of the original tenant on the date the lease was originally executed. Percentage rent must not decline substantially. The assumption or assignment of the lease is subject to all of the provisions of the lease including (but not limited to) provisions such as radius, location, use or exclusivity provisions, and that the assignment will not breach any such provision contained in any other lease, financing agreement or master agreement relating to the shopping center. Also, the assumption or assignment of the lease cannot disrupt any tenant mix or balance in the shopping center. *See In re Rickel Home Ctrs., Inc.*, 209 F.3d 291 (3d Cir. 2000); *In re Joshua Slocum, Ltd.*¸ 922 F.2d 1081 (3d Cir. 1990); *In re Federated Dep't Stores, Inc.*, 135 B.R. 941 (Bankr. S.D. Ohio 1991).

Because "shopping center" is not defined in the Bankruptcy Code, the bankruptcy courts review a number of factors to determine if a "shopping center" lease exists, including:

(a) a combination of leases;

(b) all leases held by a single landlord;

(c) all tenants engaged in the commercial retail distribution of goods;

(d) the presence of a common parking area;

(e) the purposeful development of the premises as a shopping center;

(f) the existence of a master lease;

(g) the existence of fixed hours during which all stores are open;

(h) the existence of joint advertising;

(i) contractual interdependence of the tenants as evidenced by restrictive use provisions in their leases;

(j) the existence of percentage rent provisions in the lease;

(k) joint participation by tenants in trash removal and other maintenance;

(l) the existence of a tenant mix; and

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(m) the contiguity of the stores.

In re Sun TV & Appliances, Inc., 234 B.R. 356, 360 (Bankr. D. Del. 1999).

4. Rejection Damages

Section 502(b)(6) imposes a cap on the amount of damages a landlord can assert from rejection of a lease. Section 502(b)(6) limits the landlord's claim for damages arising out of termination of the lease to the following:

(1) the rent reserved in a lease without acceleration for the greater of one year or 15% (not to exceed 3 years) of the remaining term of the lease calculated from the earlier of either the petition date or the date upon which the lessor repossessed or the lessee surrendered the premises; plus

(2) any unpaid rent due under the lease on the earlier of either the petition date or the date upon which the lessor repossessed or the lessee surrendered the lease premises.

While section 502(b)(6) is often characterized as a replacement of the state law calculation of damages arising from termination of a lease, it is more accurate to view section 502(b)(6) as a limitation on the damages recoverable by the landlord, with the statutory cap applied after the amount of actual damages under state law is determined. *See, e.g.*, *Smith v. Sprayberry Square Holdings, Inc. (In re Smith)*, 249 B.R. 328 (Bankr. S.D. Ga. 2000). Further, section 502(b)(6) addresses all damages due to non-performance including breaches of lease covenants. *In re Crown Books Corp.*, 291 B.R. 623 (Bankr. D. Del. 2003). The rationale behind section 502(b)(6) is that it provides a limitation on potentially large claims of lessors, which would otherwise arise upon rejection of long-term leases. *See EOP-Colonnade of Dallas Ltd. P'ship v. Faulkner (In re Stonebridge Techs., Inc.)*, 430 F.3d 260, 268-69 (5th Cir. 2005). In *Stonebridge*, the 5th Circuit did not apply the statutory cap to application of funds from a draw on a letter of credit because the landlord did not file a proof of claim in the bankruptcy case. Other courts have, however, applied the statutory cap before the application of any security deposit or use of proceeds from the exercise of rights under a letter of credit, thus significantly reducing the landlord's claim. Thus, it is important for a landlord to determine the applicable law in the relevant jurisdiction and determine if a proof of claim should be filed for its rejection damages if it is holding a large letter of credit or security deposit.

5. Cure Claims

If the debtor is in default, the conditions to assumption of a lease are that all defaults must be "cured," and the debtor must make a showing of adequate assurance of future performance. *In re Rachels Indus., Inc.*, 109 B.R. 797 (Bankr. W.D. Tenn. 1990). What constitutes adequate assurance of future performance is decided on a case-by-case basis. *See, e.g.*, *In re Texas Health Enters.*, 246 B.R. 832 (Bankr. E.D. Tex. 2000). The courts

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state that adequate assurance of future performance is generally less than an absolute guarantee of performance. The courts often refer to a showing by the debtor that its financial condition reflects an income stream and financial strength sufficient to meet the lease obligations, that the general economic outlook in the debtor's industry is sufficient for debtor to operate and, to the extent applicable, that a guarantee of the lease obligations by a liquid third party exists. *See In re Carlisle Homes Inc.*, 103 B.R. 524, 538 (Bankr. D.N.J. 1988).

To the extent the debtor has committed a non-monetary default under the lease or executory contract, such as violating a go dark provision in a lease by closing the debtor's location for a period beyond the limits set forth in the lease, then the debtor must cure the default by resuming performance of such provision prior to assumption of the lease or executory contract. *See* 11 U.S.C. § 365(b)(1)(A). The non-debtor party to the lease or executory contract will also be entitled to recover any pecuniary losses that were associated with the debtor's failure to previously perform its non-monetary obligations.

6. Landlord Liens

Under section 545 of the Bankruptcy Code, a trustee or debtor-in-possession may avoid the fixing of a statutory lien on property of the debtor for rent or distress for rent. *See In re A&R Wholesale Distrib., Inc.*, 232 B.R. 616, 620 (Bankr. D.N.J. 1999) (citing numerous cases affirming avoidance of landlord's lien).

C. Debtor as Lessor

Section 365(h)(1)(A) of the Bankruptcy Code provides that if a lease is rejected, the non-debtor tenant has the right to treat the lease as terminated or to "retain its rights under such lease " for the balance of the term and any renewal or extension which would be enforceable under applicable nonbankruptcy law. If a tenant elects to remain in possession, it may offset against the rent "the value of any damage caused by the nonperformance [of the landlord] after the date of such rejection." However, there is no right to demand any performance under the lease. In other words, a tenant can remain but cannot demand that the debtor/landlord perform any repairs or other lease obligations.

II. <u>Intellectual Property Issues</u>

A. Debtor as Licensor

Intellectual property is defined to include patents and copyrights, but it essentially excludes trademarks. If the debtor elects to reject a license, the non-debtor licensee may

(1) Elect to treat the license as terminated and assert a claim for rejection damages; or

(2) Retain its nonexclusive intellectual property rights "as such rights existed" immediately before the bankruptcy case.

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The licensee, however, will have no guarantee of rights to any future improvements that may be made to the patent. Additionally, the licensee must continue to make royalty payments. Trademark licensees may not have the same protection. Note, however, that in *In re Exide Techs,* ___ F.3d ___, 2010 WL 2163190, Case No. 08-1872 (3rd Circuit, June 1, 2010), the purchaser of the debtor's assets, including certain trademarks, was able to retain the right to use the trademarks as the 3rd Circuit determined that the operative sale documents, including the trademark license, was not an executory contract (which the debtor sought to reject to regain the right to use the trademarks) because there was not substantial performance due on both sides under such sale documents.

B. Debtor as Licensee

If the debtor has an exclusive license, then the debtor has the right to assign and transfer the license to a third party. In the event the debtor holds a non-exclusive license, the debtor may not be able to assign the license without the consent of the owner of the intellectual property. There is a disagreement across the federal circuits regarding whether the debtor may even assume the license for its own use without the consent of owner.

III. Mergers & Acquisitions Issues

In connection with the purchase or sale of assets outside of bankruptcy, there is a risk that the counterparty to the transaction may file for bankruptcy and the transaction will be scrutinized to determine if it constituted a fraudulent transfer. In the uncertainties of today's financial environment, it is prudent to assume that within two years after the closing, any party to any transaction may find the filing of bankruptcy to be advantageous for reasons which may be completely unrelated to a specific transaction. Buyers and sellers who recognize the inevitability of such boom and bust cycles can take steps during the due diligence and acquisition process to protect against successful prosecution of such avoidance claims.

Debtor's management is unlikely to garner congratulations for selling assets for too much money or getting a great deal on an acquisition. Rather, bankruptcy is always followed by second-guessing, including accusations that the debtor either paid above market or sold too low. Such charges can result in an action against the "lucky" seller or the "fortunate" buyer for the avoidance of the transfer and recovery of the supposedly lost value for the creditors of the debtor.

One of the less discussed 2005 amendments to the Bankruptcy Code has essentially created a four-year period of exposure. Section 548 of the Bankruptcy Code provides that suit can be initiated within two years of the filing of bankruptcy as to any transfer of an interest of the debtor in property that was made or incurred on or within two years before the date of the filing of the petition may be avoided, if the debtor received less than a reasonably equivalent value in exchange for such transfer and

(1) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer obligation;

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(2) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

(3) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

“Reasonably equivalent value” is to be calculated as of the time of the transfer, and is especially difficult to assess when the debtor acquires technology or other intangible property. A court must view the entire situation as of the time of the transfer, including the state of the technology, the legal status of the assets that were transferred (such as whether patents had actually issued), and the financial situation of the debtor. Relying on the arm’s-length nature of the transaction as the exclusive test for “value” could lead to the erroneous conclusion that value is conferred simply because the debtor parted with “the going rate.” Insulation from attack may be provided if there was an auction or bidding process or solicitations from multiple potential buyers/sellers.

As part of the agreement, a potential purchaser may seek to have certain facts included in the documentation, including:

(1) A list of parties contacted;

(2) A description of the efforts undertaken by the seller to sell the assets; and,

(3) A representation from the (future) debtor that there was fair opportunity to market the property, and that the consideration to be paid is believed to be at least reasonably equivalent to fair market value.

Of course, no representation is a guarantee of success, because the issue under Section 548 is whether the consideration actually was less than reasonably equivalent value, not what the debtor's management believed at the time.

Transactions will be subject to a heightened scrutiny where a business is sold by a future debtor and its management personnel (who often had the driving role in determining the sales price) become executives with the buyer. If management who participated in determining the sales price remains with the seller (and future debtor) but receive a financial benefit from the sale, the transaction is similarly subject to attack. Such management's motives and objectivity are subject to question or challenge, including the often persuasive argument that management saw the debtor's bankruptcy coming but promoted a sale at a bargain-basement price as part of a personal exit strategy.

Insolvency is established if a preponderance of the evidence shows that the debtor’s liabilities exceeded its assets at a fair valuation. Unfortunately for purposes of evaluating the future risks, there are no generally accepted accounting principles for analyzing the insolvency of a company. That means that positive net worth on an audited balance sheet

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is no guarantee of a finding of solvency. In undertaking the transaction, due diligence should include review of the current and, if possible, the post-transaction financial condition of the other party. Due diligence might also include an analysis of the ability of the other party to meet its post-transaction business plan, including the ability to pay obligations after the closing. Another red flag might be large and/or growing trade payables.

A future debtor is particularly susceptible to being retroactively declared to have been insolvent if it uses aggressive or unusual accounting practices or has substantial unrecognized contingent liabilities on its balance sheet. The value of major assets is difficult to ascertain, subject to major erosion, and/or subject to major write-offs, such as goodwill. All of these circumstances are caution flags to a potential buyer or seller.

Other precautionary steps to take during an M&A transaction is advising directors to document the methodology supporting the value of the assets. Additionally, management and the investor relations department should be advised to be circumspect regarding communications with investors and analysts, and members of management should be reminded that internal discussions and communications are generally discoverable. Thus, formal and informal communications relating to any acquisition or disposition should be fact-based and not contain unsupported personal opinions, speculation or quotes from unidentified sources. Buyers and sellers should take precautions against inappropriate statements in transaction documents and presentations, including:

- fairness opinions;
- diligence memos;
- presentations to boards of directors;
- board resolutions; internal memos;
- e-mails;
- correspondence;
- analyst presentations and conferences;
- press announcements;
- interviews;
- articles;
- public statements;
- non-privileged correspondence to or from outside advisors including investment bankers, underwriters, accountants, financial advisors, and venture capitalists;
- documents provided to or received from lenders;

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- information statements to shareholders or shareholder presentations;
- securities filings; and
- presentations to employees.

CONCLUSION

While a bankruptcy case may raise various issues for an organization, in-house counsel has no reason to panic. The matters that arise in bankruptcy cases may involve complex facts; however, there is a predictable pattern that transcends almost every bankruptcy case. Based on an understanding of these patterns, the appropriate actions can be taken to address the hazards that arise when a bankruptcy case is filed. Additionally, steps may be taken by the organization prior to a bankruptcy case to reduce the risks associated with the filing of a bankruptcy case. Finally, a bankruptcy case may represent an opportunity for the company to engage in strategic acquisitions.

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