

**POTENTIAL ISSUES IN MOST BUSINESS  
BANKRUPTCY CASES**

**JAY H. ONG  
MUNSCH HARDT KOPF & HARR, P.C.  
600 Congress Avenue, Suite 2900  
Austin, Texas 78701  
Telephone: (512) 391-6100  
Email: jong@munsch.com**

**State Bar of Texas  
NUTS AND BOLTS OF BUSINESS BANKRUPTCY 2007  
February 21, 2007  
Dallas, Texas  
CHAPTER 5**

## TABLE OF CONTENTS

I.	INTRODUCTION .....	1
II.	BANKRUPTCY OVERVIEW: STRUCTURE, JURISDICTION AND ADMINISTRATION.....	2
	A.    Jurisdiction and Venue.....	2
	B.    (Voluntary and) Involuntary Petitions .....	3
	1.    Standing .....	3
	2.    Process and Standard for Relief.....	4
	3.    Gap Period; Sanctions.....	5
	C.    Additional Overview / Structure.....	5
	1.    Chapter 7 Liquidation .....	6
	2.    Chapter 11 Reorganization .....	6
III.	THE AUTOMATIC STAY .....	6
	A.    Scope and Impact of the Automatic Stay.....	6
	B.    Key Exceptions to Creditors .....	7
	1.    Perfection/Re-Perfection of Security Interests.....	8
	2.    Recovery of Nonresidential Real Property Subject to Lease .....	8
	3.    Setoff of Swap Obligations, Securities, Commodities, and Forward Contracts .....	9
	4.    Transfers Unavoidable Under Sections 544 and 549.....	9
	5.    Doctrine of Recoupment .....	9
	C.    Other Protections in Relation to Stay.....	10
	1.    Preservation of Setoff Rights .....	10
	2.    Reclamation Rights.....	10
	D.    Relief from the Stay .....	11
	1.    “For Cause”.....	11
	2.    Lack of Adequate Protection .....	12
	3.    No Equity and Not Necessary.....	12
	4.    Single Asset Real Estate Cases .....	13
IV.	CASH COLLATERAL.....	13
	A.    Cash Collateral” Defined.....	14
	B.    Limitations on Use.....	14
	1.    Consent v. Court Authorization .....	14
	2.    Sales .....	14
	3.    Required Segregation of Cash Collateral.....	15
V.	EXECUTORY CONTRACTS AND UNEXPIRED LEASES .....	15
	A.    Overview of Section 365 of Code.....	15
	1.    “Executory” Defined.....	15
	2.    Ipso Facto Clauses Unenforceable.....	16
	B.    Assumption or Rejection.....	17
	1.    Impact of Rejection.....	17
	2.    Requirements for Assumption / Assignment .....	18
	C.    Time Limitations and Payment Requirements.....	18
VI.	EVIDENCING PRE-PETITION CLAIMS IN THE CASE .....	19
	A.    Debtor’s Schedules v. Proof of Claim .....	19
	B.    Timing for Filing.....	20
	C.    Secured Claims .....	20
	1.    Bifurcation of Claims Under Section 506 of Code .....	20
	2.    Section 1111(b) Election.....	21
	D.    Claims Objections.....	21
VII.	CONFIRMATION ISSUES IN CHAPTER 11 .....	21
	A.    The Chapter 11 Plan and Its Purpose .....	21
	B.    The Disclosure Statement and Its Purpose.....	22

C.	Use of the Class Structure and Impact .....	22
1.	Requirements of Classification .....	22
2.	Percentage Vote Required.....	23
D.	Critical Confirmation Standards .....	23
1.	“Best Interest of Creditors” Test.....	23
2.	Feasibility.....	23
3.	Compliance with Other Provisions of the Bankruptcy Code .....	23
E.	The Cramdown Alternative.....	23
1.	Requirements .....	23
2.	Fair and Equitable Treatment of Secured Claims .....	24
3.	Fair and Equitable Treatment of Unsecured Claims .....	25
VIII.	AVOIDANCE ACTIONS.....	26
A.	Overview and Purpose of Avoidance Actions .....	26
B.	Preference Actions .....	26
1.	Requirements .....	27
2.	Key Defenses .....	27
C.	“Strong Arm” Actions.....	29
D.	Fraudulent Conveyances .....	29
IX.	STRATEGIES FOR CONTROLLING A CHAPTER 11 CASE .....	30
A.	Appointment of Chapter 11 Trustee.....	30
B.	Examiners .....	30
C.	Plan Exclusivity and Competing Plans .....	31
D.	Committee Representation.....	31
E.	Conversion and Dismissal.....	32
X.	CONCLUSION.....	32

# POTENTIAL ISSUES IN BUSINESS BANKRUPTCY CASES

## I. INTRODUCTION

Since the turn of the millennium, our bankruptcy system has been in the throes of a great state of flux. It has traversed the historical highs of one of the greatest bankruptcy booms in United States history, rebounded equally strongly into a period of near inactivity, and along the way, the bankruptcy system itself has undergone substantial restructuring.

The aforementioned crest arose largely from the bursting of the Dot-Com bubble, as the national economy slid into a period of recession in late 2000 and early 2001.<sup>1</sup> This trend included not only more business bankruptcies generally, but also began a peak of “mega” cases involving enormous restructurings of business debts and operations, and with them, naturally, rose the complexity of issues they presented as the amounts at stake and universe of interests implicated grew correspondingly.<sup>2</sup> Many of the more prominent cases continue to ring in the national consciousness: Enron, K-Mart, WorldCom, and Global Crossing – all of these sought protection from their creditors under Chapter 11 of the Bankruptcy Code during this period.<sup>3</sup> In fact, of the fifteen largest business bankruptcies to have occurred in the past twenty-six years, eleven have been commenced since 2001.<sup>4</sup>

Just when it began to feel as though the bankruptcy heyday might never end, the economy began to turn the corner, and with it, bankruptcies around the middle of 2004 through 2005 began to recede from their unprecedented levels.<sup>5</sup> By late 2006, business bankruptcy filings had declined over sixty percent from the rate of business bankruptcy filings in 2005.<sup>6</sup>

In the midst of this fluctuation, perhaps not coincidentally so, loomed legislative reforms throwing into question the future workings of the Bankruptcy Code.<sup>7</sup> These ultimately culminated in the enactment of the Bankruptcy Abuse and Consumer Protection Act of 2005 (“BAPCPA”), which was signed into law by the President on April 20, 2005.<sup>8</sup> BAPCPA – which generally became effective on October 17, 2006, but with some provisions taking immediate effect – has received considerable attention in the consumer bankruptcy arena due to its “means testing” and other controversial consumer directed provisions.<sup>9</sup> However, its amendments and revisions to the Bankruptcy Code include numerous significant and sometimes sweeping alterations to the business bankruptcy process as well, the aggregate impact of which will take years for the courts, practitioners and commentators to fully assess.<sup>10</sup> Indeed, it seemed that no sooner had BAPCPA become effective than a

---

business\_Bankruptcy\_Filings&Template=/TaggedPage/TaggedPageDisplay.cfm&TPLID=59&ContentID=34626

<sup>1</sup> See Kathy Hoke, *Bankruptcy Filings Grow*, Columbus Business First (May 24, 2002), <http://www.bizjournals.com/columbus/stories/2002/05/27/story3.html?page=2> (last visited January 3, 2007); Larry Elliot, *Six Years Ago the Dotcom Bubble Burst, Now Markets are Soaring Again* (May 9, 2006), <http://money.guardian.co.uk/investments/shares/story/0,,1770858,00.html> (last visited January 5, 2007).

<sup>2</sup> See William Jenkins Jr., *Weighted Case Filings as a Measure of Judge's Case-Related Workload*, Test. Before Subcomm. on Commercial and Admin. Law, Comm. on Judiciary, H.R., U.S. GAO-03-789T, at p. 6 (May 22, 2003).

<sup>3</sup> *The 15 Largest Bankruptcies 1980 – Present*, [http://www.bankruptcydata.com/Research/15\\_Largest.htm](http://www.bankruptcydata.com/Research/15_Largest.htm) (last visited January 5, 2007).

<sup>4</sup> *Id.* Although total bankruptcy filings, business bankruptcies and the incidence of mega-cases increased beginning in 2001, business bankruptcies generally have steadily declined since the mid to late 1980's. *Annual Business and Non-business Filings by Year (1980-2005)*, [http://www.abiworld.org/AM/Template.cfm?Section=Business\\_Bankruptcy\\_Filings&Template=/TaggedPage/TaggedPageDisplay.cfm&TPLID=59&ContentID=34626](http://www.abiworld.org/AM/Template.cfm?Section=Business_Bankruptcy_Filings&Template=/TaggedPage/TaggedPageDisplay.cfm&TPLID=59&ContentID=34626)

<sup>5</sup> John D. Penn, *Is this Economic Cycle Going Anywhere We'd Like to Go?* (July 2006), <http://www.abiworld.org/AM/Template.cfm?Section=Home&CONTENTID=41346&TEMPLATE=/CM/ContentDisplay.cfm> (last visited January 5, 2007).

<sup>6</sup> John Hartgen, *Bankruptcy Filings During First Three Quarters Of 2006 Drop Off Nearly One Million From Previous Year* (December 5, 2006), <http://www.abiworld.org/AM/Template.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=44794> (last visited January 5, 2007).

<sup>7</sup> See Melissa B. Jacoby, *Ripple or Revolution? The Indeterminacy of Statutory Bankruptcy Reform*, 79 Am. Bankr. L.J. 169, 190 (Spring 2005).

<sup>8</sup> See *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)*, <http://www.usdoj.gov/ust/eo/bapcpa/index.htm> (last visited January 5, 2007).

<sup>9</sup> See Hon. William H. Brown, *Taking Exception to a Debtor's Discharge: The 2005 Bankruptcy Amendments Make It Easier*, 79 Am. Bankr. L.J. 419, 424 (Spring 2005); Jacoby, *supra* note 7, at 169 n. 2, 171.

<sup>10</sup> Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 Am. Bankr. L.J. 603, 603-04 (Summer 2005).

number of courts promptly proceeded to declare certain of its provisions unconstitutional.<sup>11</sup>

Even against this still-morphing back drop, there nevertheless remain a number of substantial issues which arise in most, or even virtually all, business bankruptcy cases. These issues constitute the focus of this discussion, which generally proceeds along the usual chronology of a business bankruptcy case. We begin with a brief overview of the statutory scheme and structure of the Bankruptcy Code.

## II. BANKRUPTCY OVERVIEW: STRUCTURE, JURISDICTION AND ADMINISTRATION

### A. Jurisdiction and Venue

Pursuant to Article I, Section 8, of the U.S. Constitution, Congress has the power to establish a uniform set of laws on bankruptcies and has utilized such power to establish a national set of bankruptcy laws.<sup>12</sup> In 1978, Congress substantially overhauled the then-existing set of statutory provisions by enacting the Bankruptcy Code, which, subject to certain amendments made thereto since 1978, remains in force today.<sup>13</sup>

Original and exclusive jurisdiction over all bankruptcy cases is vested in the U.S. District Courts.<sup>14</sup> The district courts, however, have the authority to refer such cases to the U.S. Bankruptcy Courts for resolution, and typically do so by standing order.<sup>15</sup> Additionally, upon the filing of a bankruptcy case, all property of the debtor vests in a bankruptcy estate, and the district court (and bankruptcy court by referral) also obtains jurisdiction over all property of the debtor and estate.<sup>16</sup> Finally, a bankruptcy proceeding is only rendered meaningful and capable of completion if the debtor's assets and liabilities are capable of determination. Therefore, the district courts (and bankruptcy courts by referral) also have original, but not exclusive, jurisdiction over all civil proceedings

“arising under,” “arising in,” or “related to” a bankruptcy case.<sup>17</sup>

The issue of proper venue for bankruptcy cases (i.e., where a given business – or person – may be a debtor under the Bankruptcy Code) is one of the most unique aspects of the Bankruptcy Code which can simultaneously be extremely attractive to business debtors and frustrating to their creditors. In fact, the provision of the United States Code governing venue of bankruptcy cases is not found in the Bankruptcy Code at all, but rather, it is contained in section 1408 of Title 28. That provision provides in pertinent part that a bankruptcy case may be commenced in any federal district:

(1) in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of such case have been located for the one hundred and eighty days immediately preceding such commencement, or for a longer portion of such one-hundred-and-eighty-day period than the domicile, residence, or principal place of business, in the United States, or principal assets in the United States, of such person were located in any other district; or

(2) in which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership.<sup>18</sup>

To fully understand the import of these provisions, it must be recognized that case law construes the “domicile” and “residence” of business “persons” under the statute to be their place of incorporation.<sup>19</sup> This framework provides extremely broad flexibility for business debtors to determine what venue for their bankruptcy cases might be most advantageous. Especially in the case of larger businesses, the district where a company's primary assets are located may be different from the location of its headquarters (principal place of business), while its place of incorporation may, itself, be an entirely

<sup>11</sup> See *Hersh v. United States*, 347 B.R. 19, 23-25 (N.D. Tex. 2006); *Milavetz, Gallop & Milavetz P.A. v. United States*, 2006 U.S. Dist. LEXIS 88785, \*12-13 (D. Minn. 2006); *Zelotes v. Martini*, 352 B.R. 17, 24-25 (D. Conn. 2006).

<sup>12</sup> U.S. Const. art. I, § 8.

<sup>13</sup> 11 U.S.C. § 101, *et seq.* (1978). All further citations to the Bankruptcy Code are to its current version (2005), unless otherwise indicated.

<sup>14</sup> 28 U.S.C. § 1334(a).

<sup>15</sup> See 28 U.S.C. § 157(a).

<sup>16</sup> See 11 U.S.C. § 541; 28 U.S.C. § 1334(e).

<sup>17</sup> See 28 U.S.C. §§ 157(a), 1334(b).

<sup>18</sup> 28 U.S.C. § 1408.

<sup>19</sup> See, e.g., *In re Ocean Properties of Delaware, Inc.*, 95 B.R. 304, 305 (Bankr. D. Del. 1988). See also Theodore Eisenberg & Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations*, 84 Cornell L. Rev. 967, 984-85 (1999). See also 28 U.S.C. § 1391(c). This statute provides that a corporation is deemed to reside in a district in which it is subject to personal jurisdiction.

different district. Therefore, a business generally located in Texas and having Texas based operations and creditors might commence its bankruptcy case in Delaware, where many businesses are incorporated to take advantage of favorable corporate laws.<sup>20</sup> The additional ability to commence a case in any district where the case of an affiliate is pending further broadens the options for larger businesses, because they may use affiliates or subsidiaries to file in favorable jurisdictions and subsequently bootstrap their own cases to the same jurisdiction. Such flexibility can be extremely prejudicial to smaller, more localized creditors, who may not have the wherewithal to prosecute their interests in proceedings thousands of miles distant, even if their interests are sufficiently large to justify the effort.<sup>21</sup> While creditors do have the possible remedy of seeking transfer of a bankruptcy case located in an inconvenient forum, such transfers rarely occur.<sup>22</sup>

### B. (Voluntary and) Involuntary Petitions

A bankruptcy case is commenced by the filing of a bankruptcy petition. Under the Bankruptcy Code, a bankruptcy proceeding may be either voluntarily commenced by a debtor, or involuntarily forced upon the debtor by creditors.<sup>23</sup> Voluntary petitions are fairly straightforward and the vast majority of bankruptcy cases are commenced this way.<sup>24</sup>

As strange as it may sound, under the right circumstances, bankruptcy may be exactly where a creditor wants the debtor, particularly if it suspects that the debtor's principals are running the company into

the ground, or even worse, embezzling funds from the debtor's coffers. If the creditor also either has not been able to marshal enough evidence to show such negligence or malfeasance or does not have sufficient resources to pursue the appointment of a receiver or to seek other state court remedies, then a controlled bankruptcy proceeding may be enviable.

The bankruptcy process is designed to address such matters by implementing substantial oversight over the debtor's affairs. Among other things, upon the filing of a bankruptcy case: (i) the bankruptcy court and U.S. Trustee's office get involved and have the ability to monitor activities of the debtor; (ii) often an official unsecured creditors' committee is appointed (in Chapter 11 cases) which has a significant voice in the case on behalf of all unsecured creditors; (iii) all transactions out of the ordinary course of business are subject to notice and court approval; (iv) certain disclosures are required of the debtor (e.g., the debtor's listing of assets and liabilities); and (v) a trustee may be appointed (and is appointed in all Chapter 7 cases) to take over control of the debtor. The Bankruptcy Code also contains certain avoidance causes of action which may enable the recovery of transfers made by the debtor shortly before the bankruptcy filing.

Section 303 of the Bankruptcy Code accordingly provides for the filing of petitions to commence involuntary bankruptcy cases, and is organized to address: (i) who can commence an involuntary case; (ii) the standard for entry of an order adjudicating the debtor a bankrupt; (iii) debtor activities during the period between the filing of the petition and the entry of an order for relief or dismissal; and (iv) the grounds for and consequences of dismissal if the involuntary proceedings was improperly filed.

#### 1. Standing

Involuntary petitions may be commenced only under Chapters 7 and 11 of the Bankruptcy Code, are generally available for business corporations and partnerships, and must be commenced by 3 or more creditors, "each of which is either a holder of a claim against [the debtor] that is not contingent as to liability or the subject of a bona fide dispute...if such claims aggregate at least \$12,300 more than the value of any lien on property of the debtor securing such claims."<sup>25</sup> In short, at least three creditors with at least the minimum aggregate amount of noncontingent and undisputed, *unsecured* claims must unite to commence an involuntary bankruptcy case. However, if the

<sup>20</sup> See Demetrios G. Kaoris, *Is Delaware Still a Haven for Incorporation?*, 20 Del. J. Corp. L. 965, 966 (1995); Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. Cin. L. Rev. 1061, 1061-62 (2000).

<sup>21</sup> In addition to the obvious increase in travel expense and the inconvenience of remoteness from the bankruptcy court, creditors will often have to absorb the added expense of proliferated counsel due to local counsel requirements used in various jurisdictions. See, e.g., Local Rules of Bankruptcy Procedure 9010-1 for the District of Delaware (District Court Local Rule 83.5(d) shall generally apply to all bankruptcy proceedings); Local Rule of Civil Procedure 83.5(d) for the District of Delaware (Association with local counsel is required). These considerations are further magnified by the incentives debtors have to take advantage of this flexibility due to the obvious benefits derived from minimizing creditor participation.

<sup>22</sup> Eisenberg & LoPucki, *supra* note 19, at 1000.

<sup>23</sup> See 11 U.S.C. §§ 301, 303.

<sup>24</sup> 2 *Collier on Bankruptcy* ¶ 303.01 (Alan N. Resnick et al. eds., 15<sup>th</sup> rev. ed. 2006) (hereinafter *Collier's*).

<sup>25</sup> 11 U.S.C. § 303(b)(1). The burden of proof on such issues is on the petitioning creditors. *In re Reid*, 773 F.2d 945 (7th Cir. 1985).

potential debtor is of a size that it has fewer than 12 such creditors (excluding insiders), then any 1 or more creditors with noncontingent and undisputed claims aggregating the minimum threshold may commence the case.<sup>26</sup>

In the event that one or more of the petitioning creditors turns out to be ineligible to bring the involuntary petition, section 303 additionally provides that such deficiency may be cured subsequent to the filing of the involuntary petition filing through the joinder of other eligible creditors in the involuntary petition, but only if such joinder occurs prior to dismissal of the case.<sup>27</sup> This enables the initial petitioning creditors to solicit the joinder of other qualifying creditors to ensure compliance with the filing requirements.<sup>28</sup> The case law which has grown up around this section is inconsistent, however, and some courts hold that where an involuntary petition is clearly insufficient on its face, or where bad faith is indicated, such joinder is impermissible.<sup>29</sup> Accordingly, while section 303(c) may be used to “repair” a defective petition, creditors must make every effort to comply with the requirements from the outset, reserving resort to the joinder provision only where intervening events or discoveries make it necessary to do so.

## 2. Process and Standard for Relief

Plainly, that a putative debtor might challenge the propriety of an involuntary case is anticipated by its very nature. The filing of an involuntary petition is accompanied by a summons, and the petitioning creditors must serve both the petition and summons on the debtor.<sup>30</sup> A debtor has twenty days from the date of service of the summons to respond.<sup>31</sup> If uncontroverted by the debtor, the bankruptcy court will enter an order (an “order for relief”) formally authorizing the bankruptcy to proceed under the applicable Chapter of the Bankruptcy Code requested by the petitioning creditors.<sup>32</sup> On the other hand, if the involuntary petition is contested by the debtor, the

bankruptcy court will conduct a trial on the merits (depending upon the areas of dispute raised by the debtor) to determine whether to dismiss the case or enter the order for relief.<sup>33</sup>

Section 303 also incorporates into its provisions a standard to assist the courts in resolving these disputes. If the petition is not defective, the court must nevertheless dismiss the case unless it finds that the debtor is “generally not paying its debts as they become due, unless such debts are the subject of a bona fide dispute.”<sup>34</sup> In applying the standard, courts typically look at and balance a number of factors, with none being dispositive and the weight afforded each determined on a case by case basis.<sup>35</sup>

The factors include: (i) the number of unpaid creditors; (ii) the amount of the overall delinquency; (iii) the materiality of the non-payment; and (iv) the nature and conduct of the debtor’s business.<sup>36</sup> Additional supporting factors include: (i) the debtor’s ability to satisfy only small periodic payments, but not long-term obligations; (ii) any rapid decline in the value of the debtor’s assets resulting from asset sales rather than profit generating activity; (iii) the amount of the debtor’s liabilities compared to the debtor’s yearly income; (iv) whether there has been a voluntary shut-down of operations; (v) whether insiders of the debtor have deferred the debtor’s payment to creditors on account of loans payable by the debtor to them; (vi) serious allegations regarding the conduct and management of the debtor’s business; (vii) any apparent bad faith evidenced by corporate officers taking of loans despite the company’s financial distress; (viii) whether there have been payments made by insiders to the debtor both before and after filing; (ix) whether there have been payments made by third parties to the debtor or a waiver of claims by a third party; (x) the debtor’s statement or indication of a subjective desire to pay the debts; (xi) whether the debtor has liquidated its assets; (xii) whether the debtor’s defaults only relate to extraordinary debts; (xiii) whether payments have been made by partners,

<sup>26</sup> 11 U.S.C. § 303(b)(2). Recipients of voidable transfers are also excluded from the realm of possible petitioning creditors.

<sup>27</sup> 11 U.S.C. § 303(c).

<sup>28</sup> See 2 *Collier’s* ¶ 303.9.

<sup>29</sup> See, e.g., *Atlas Mach. & Iron Works, Inc. v. Bethlehem Steel Corp.*, 986 F.2d 709, 714 (4th Cir. 1993). But see *IBM Credit Corp. v. Compuhouse Systems, Inc.*, 179 B.R. 474, 477 (W.D. Pa. 1995) (joinder is matter of right).

<sup>30</sup> Fed. R. Bankr. P. 1010.

<sup>31</sup> Fed. R. Bankr. P. 1011(b).

<sup>32</sup> 11 U.S.C. § 303(h).

<sup>33</sup> See *In re Xacur*, 219 B.R. 956, 963 (S.D. Tex. 1998).

<sup>34</sup> 11 U.S.C. § 303(h)(1). The precise language here should be distinguished from the *ability* to generally pay debts as they become due. Alternatively, the court may sustain the case if it finds that the putative debtor has been subjected to a receivership or similar trusteeship within 120 days of the filing of the petition. 11 U.S.C. § 303(h)(2).

<sup>35</sup> See *In re The Food Gallery at Valleybrook*, 222 B.R. 480, 487 (Bankr. W.D. Pa. 1998).

<sup>36</sup> See *In re Tarletz*, 27 B.R. 787, 789-90 (Bankr. D. Colo. 1983).

individually, of a debtor partnership even though the debts were those of the partnership; and (xiv) whether the due and unpaid debts are comprised entirely of the claims of the petitioning creditors while other non-petitioning creditors have been paid.<sup>37</sup>

A putative debtor may also defend against an involuntary petition under section 305 of the Bankruptcy Code (Abstention), which provides that a bankruptcy court may dismiss or suspend a bankruptcy case if it determines that “the interest of creditors and the debtor would be better served by such dismissal or suspension.”<sup>38</sup>

### 3. Gap Period; Sanctions

The time between the filing of an involuntary petition and when the court finally rules on the propriety of the filing is commonly referred to as the “gap” period. During the gap period, to minimize the disruption on the debtor’s affairs pending the court’s determination, the debtor may continue to operate its business in the same manner as it operated prior to the filing.<sup>39</sup>

On the other hand, one of the main reasons for filing an involuntary case may be to remove the debtor’s principals from control over the debtor where there is some concern over malfeasance. Accordingly, during this gap period, the bankruptcy court may, upon request (and after a hearing), appoint an interim trustee where it appears that assets of the estate may be in jeopardy, such as where management appears to be attempting to quickly dispose of them during the gap period.<sup>40</sup> Even where a “gap trustee” is appointed, the debtor may regain possession of its assets by posting a bond with the court, but if an order for relief is ultimately entered, the debtor must redeliver the property or its value to any trustee appointed and account for all property obtained by the debtor.<sup>41</sup>

Mindful that involuntary bankruptcy petitions are rather extreme measures, petitioning creditors must be meticulous in their analysis of the requirements and their application to the relevant facts. Initially, if the bankruptcy court finds cause to do so (after notice and a hearing), it may order petitioning creditors to post a bond with the court to indemnify the debtor against any damages awarded by the court to the debtor on account of an unwarranted filing.<sup>42</sup> Moreover, section 303 also

expressly entitles a putative debtor successful in challenging an involuntary petition to damages, including punitive damages, occasioned by the (potentially extremely detrimental) impacts that the bankruptcy proceedings may have had on the debtor’s business.<sup>43</sup>

### C. **Additional Overview / Structure**

Subsequent to its commencement, administration of the bankruptcy case takes place primarily through the filing of motions by and against the debtor. A separate set of procedural rules, the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”), govern such proceedings. Certain disputes which are more complex in nature and generally involve an isolated number of parties (as opposed to matters which generally affect the debtor and all of its creditors), such as lien disputes, collection actions, avoidance actions, injunction requests, and declaratory judgment actions, are subject to separate adjudication and docketing as “adversary proceedings,” which may generally be viewed as distinct and discrete pieces of litigation under or related to a bankruptcy case.<sup>44</sup> The Bankruptcy Rules also govern the conduct of adversary proceedings, and in so doing, generally incorporate the provisions of the Federal Rules of Civil Procedure as well.

Fundamental to the Bankruptcy Code are numerous provisions regulating the priority of distribution rights among various types of creditors. As one might expect, the overall priority scheme set forth within, or otherwise acknowledged by, the Bankruptcy Code ranks claims in priority from highest to lowest, generally as follows: secured claims; unsecured claims; and equity interests. Within the unsecured claim arena, the Bankruptcy Code further stratifies priorities. For example, claims incurred in administering the case, certain employment-related claims (up to a dollar limit), and certain tax claims, are given a higher priority than strictly trade-based claims.<sup>45</sup> Additionally, certain types of unsecured

<sup>37</sup> See 2 *Collier's* ¶ 303.14[1][b].

<sup>38</sup> 11 U.S.C. § 305(a)(1).

<sup>39</sup> 11 U.S.C. § 303(f).

<sup>40</sup> See 11 U.S.C. § 303(g).

<sup>41</sup> See *id.*

<sup>42</sup> 11 U.S.C. § 303(e).

<sup>43</sup> See, e.g., *In re Reid*, 773 F.2d 945, 946 (7th Cir. 1985); 11 U.S.C. § 303(i). Subsection (l) further provides for additional protections to an entity subjected to an improper involuntary case in certain circumstances, including sealing case records and injunctions against credit reporting agencies.

<sup>44</sup> See Fed. R. Bankr. P. 7001 (listing those actions which are subject to filing as adversary proceedings).

<sup>45</sup> See, e.g., 11 U.S.C. §§ 507 (listing priorities of certain unsecured claims), 726 (detailing priority in distribution under Chapter 7), 1129(a)(7)(A)(ii) (effectively incorporating same distribution priorities as are set forth within § 726).

claims are automatically subordinated to other claims, such as certain securities based claims, and/or may be subordinated by the bankruptcy court in appropriate circumstances.<sup>46</sup>

Finally, the Bankruptcy Code is divided into Chapters as follows: Chapter 7 (liquidation cases), Chapter 9 (municipality bankruptcies), Chapter 11 (reorganization cases), Chapter 12 (family farmer cases), and Chapter 13 (individual reorganization cases). We focus herein on issues pertaining to the two types of cases pertinent to business debtors and their creditors: Chapter 7 and Chapter 11 cases.

### 1. Chapter 7 Liquidation

Chapter 7 of the Bankruptcy Code is the chapter for “straight” liquidations. Chapter 7 cases essentially entail the marshalling of the debtor’s assets for orderly liquidation, with the proceeds to be distributed to the debtor’s creditors in accordance with established priorities. In all Chapter 7 cases a Chapter 7 trustee is promptly appointed by the Office of the United States Trustee to manage the debtor’s affairs and administer the case.<sup>47</sup> Because Chapter 7 involves the complete liquidation of a business debtor’s assets, there is no discharge of indebtedness for the business debtor and the end result of a Chapter 7 case is likely the dissolution of the corporation, although occasionally the corporate “shell” may be sold to a third party free and clear of all claims, liens, and other encumbrances.<sup>48</sup>

### 2. Chapter 11 Reorganization

Under Chapter 11 a business debtor may, as an alternative to a straight liquidation, reorganize its affairs so as to remain viable as an ongoing operation. A trustee is not automatically appointed in a Chapter 11 case. Instead, the debtor acts as a “debtor-in-possession,” maintaining control over assets of the estate and the business’ operations and effectively acting as a trustee with the same duties and obligations in administration of the case as a trustee would otherwise have.<sup>49</sup> Ultimately, the debtor’s restructuring proposal takes the form of a plan of reorganization which is subject to approval by the debtor’s creditors and confirmation by the bankruptcy court.<sup>50</sup> In very general terms, a Chapter 11 plan may only be approved by the bankruptcy court if creditors are assured to receive as much under the plan as they would receive under a straight Chapter 7 liquidation,

and the requisite creditor groups have voted to accept the plan.<sup>51</sup> To facilitate the reorganization, the natural conclusion of a Chapter 11 case is the debtor’s discharge from all debt incurred, and all claims arising, prior to confirmation of the debtor’s plan of reorganization except as expressly carried forward pursuant to the plan.<sup>52</sup>

Because of the numerous confirmation requirements which must be met by a debtor to obtain approval of a plan, and the voting requirements associated with plan acceptance, Chapter 11 cases are often extremely complex, highly contested, costly, and lengthy in duration.<sup>53</sup> In part due to these considerations, many of the provisions of BAPCPA pertaining to business bankruptcies are directed toward curtailing the duration and expense of bankruptcy cases, such as limitations on exclusivity periods during which only a debtor may propose a plan, more firm deadlines for the debtor to make various decisions regarding the restructuring of its assets, and limitations on severance packages and incentive plans for management.<sup>54</sup>

## III. THE AUTOMATIC STAY

### A. Scope and Impact of the Automatic Stay

One central feature of the Bankruptcy Code and the relief it provides to debtors is the “automatic stay” found in section 362.<sup>55</sup> The automatic stay arises immediately on the filing of a petition, and in the nature of an injunction, effectively imposes a moratorium on all actions against the debtor and property of the estate.<sup>56</sup> Its purpose is, at least in part,

<sup>51</sup> The various requirements for the confirmation of a plan are generally found in section 1129. More on these requirements hereinbelow.

<sup>52</sup> See 11 U.S.C. §§ 1123, 1141.

<sup>53</sup> See Hon. A. Thomas Small, *If you Fix It, They Will Come – A New Playing Field for Small Business Bankruptcies*, 79 Am. Bankr. L.J. 981, 981-82 (Fall 2005).

<sup>54</sup> See Levin & Ranney-Marinelli, 79 Am. Bankr. L.J. at 620-21, 631. Note that the reference here to minimizing expense refers to the overall systemic cost of a bankruptcy case on all involved parties, and not necessarily to the debtor. In fact, many of BAPCPA’s provisions refine the process by expressly providing for certain, mandatory treatment for various types of claims. This in turn, frequently results in a greater total universe of priority claims which the Debtor’s estate must resolve.

<sup>55</sup> 11 U.S.C. § 362(a).

<sup>56</sup> *In re S.I. Acquisition, Inc.*, 817 F.2d 1142, 1146 (5th Cir. 1987); *Compton Corp. v. U.S. Dept. of Energy (In re Compton Corp.)*, 90 B.R. 798, 803 n.14 (Bankr. N.D. Tex. 1988).

<sup>46</sup> See 11 U.S.C. § 510.

<sup>47</sup> 11 U.S.C. §§ 701, 702.

<sup>48</sup> See 11 U.S.C. § 727(a).

<sup>49</sup> See 11 U.S.C. §§ 1107, 1108.

<sup>50</sup> See 11 U.S.C. §§ 1121, 1123 and 1129.

to give the debtor a “breathing spell” from its creditors and to protect against a race to the courthouse by creditors seeking to collect on unpaid debts. This “breathing spell” further enables the bankruptcy court to enter any appropriate orders to effectuate control over assets of the debtor, and gives the court and creditors an opportunity to evaluate the debtor’s financial condition.<sup>57</sup> Accordingly, among the first issues that debtors and creditors must face upon the commencement of the case are assessments of how best to navigate and/or or enforce the provisions of the stay.

The scope of the automatic stay is broad. Formal service of process is not required to effectuate it and no particular notice need be given in order to subject a party to the stay.<sup>58</sup> Generally, the stay precludes any act to obtain possession of, or exercise control over, property of the estate, as well as any act to collect, assess, or recover any claim from the debtor that arose prior to the filing of the bankruptcy case.<sup>59</sup> All proceedings which could have been commenced by the time of the petition are stayed, including arbitration, administrative, and judicial proceedings.<sup>60</sup> The stay also prohibits the enforcement of pre-petition judgments, and any act to create, perfect or enforce a lien against property of the estate or of the debtor.<sup>61</sup> It is sufficiently broad to cover a wide variety of routine and informal acts of collection including telephone calls, demand letters, or other forms of communication or harassment directed to the debtor.<sup>62</sup> It even goes so far as to preclude a creditor’s setoff of debts owing to the debtor as of the bankruptcy filing against claims against the debtor.<sup>63</sup>

Violations of the stay carry certain ramifications. First, actions taken in violation of the stay are void, or voidable, even where there the violator has no actual notice of the existence of the stay.<sup>64</sup> Thus, for

example, if a creditor forecloses on collateral of the debtor after the bankruptcy is filed, and without first obtaining relief from the automatic stay, the foreclosure will either be treated as completely void, or may be voided by the debtor. Significantly, violations of the stay may even result in a finding of contempt by the bankruptcy court and an award of sanctions where the violator had actual notice of the bankruptcy case and stay.<sup>65</sup> However, because subsection 362(k) providing for the recovery of damages for violations of the stay refers to recovery by an “individual” harmed by the offending conduct, this has given rise to a split among the courts as to whether business debtors may recover such damages at all.<sup>66</sup> It should be noted that many of the courts holding that damages under section 362(k) are unavailable to corporate debtors also recognize that a court’s inherent powers to remedy contempt may serve as an adequate alternative.<sup>67</sup> In any event, where there is any question as to whether the stay applies to certain actions, the most prudent approach is to seek relief from the stay.<sup>68</sup>

## B. Key Exceptions to Creditors

While the scope of the automatic stay is extremely broad, Congress has expressly recognized certain exceptions to the stay, most of which are based upon certain policy considerations.<sup>69</sup> The most obvious example is that the stay does not preclude the commencement or continuation of criminal proceedings against the debtor.<sup>70</sup> Most relevant to creditors of a business debtor are the following exceptions:

---

as completely void. *See, e.g., Maritime Electric Co. v. United Jersey Bank*, 959 F.2d 1194 (3d Cir. 1992).

<sup>57</sup> *See e.g., In re Crysler / Montenay Energy Co.*, 902 F.2d 1098, 1104-05 (2d Cir. 1990) (deliberate stay violation gives rise to actual damages, and punitive damages are available for malicious or bad faith violations).

<sup>58</sup> *See In re Just Brakes Corporate Sys., Inc.*, 108 F.3d 881, 884-85 (8th Cir. 1997); *Jove Eng’g, Inc. v. IRS*, 92 F.3d 1539, 1542 (11th Cir. 1996); *In re Goodman*, 991 F.2d 613, 619 (9th Cir. 1993); *In re Chateaugay Corp.*, 920 F.2d 183, 184-85 (2d Cir. 1990). *Cf. In re Atlantic Bus. & Community Corp.*, 901 F.2d 325, 329 (3d Cir. 1990); *Budget Serv. Co. v. Better Homes of Virginia, Inc.*, 804 F.2d 289, 292 (4th Cir. 1986). Subsection 362(k) was section 362(h) prior to BAPCPA.

<sup>59</sup> *See, e.g., Just Brakes, supra* note 66, at 85; *Jove Eng’g, Inc., supra* note 66, at 1553; *Goodman, supra* note 66, at 620.

<sup>60</sup> Even where the advice of counsel is obtained, the creditor may not use mistaken advice as a defense to the violation. *See Taylor v. Tsafaroff*, 884 F.2d 478, 483 (9th Cir. 1989).

<sup>61</sup> *See* 11 U.S.C. § 362(b); 3 *Collier’s* ¶ 362.05.

<sup>62</sup> *See* 11 U.S.C. § 362(b)(1).

<sup>57</sup> *See Hunt v. Bankers Trust Co.*, 799 F.2d 1060, 1069 (5th Cir. 1986); *Hillblom v. Continental Air Lines, Inc. (In re Continental Air Lines, Inc.)*, 61 B.R. 758, 775 n.36 (S.D. Tex. 1986).

<sup>58</sup> *Job v. Calder (In re Calder)*, 907 F.2d 953 (10th Cir. 1990).

<sup>59</sup> 11 U.S.C. § 362(a)(3),(6).

<sup>60</sup> *See* 11 U.S.C. § 362(a)(1).

<sup>61</sup> 11 U.S.C. § 362(a)(2), (4) and (5).

<sup>62</sup> *See* 3 *Collier’s* ¶ 362.03[8][a].

<sup>63</sup> *See* 11 U.S.C. § 362(a)(7). *But see* discussion below regarding recoupment.

<sup>64</sup> In the Fifth Circuit, actions in violation of the stay are most often treated as voidable rather than void *ab initio*. *See, e.g., In re Chunn*, 106 F.3d 1239, 1242 n.6 (5th Cir. 1997). Other courts treat actions in violation of the stay

- a. The perfection, or the maintenance or continuation of perfection, of interests in property (under certain circumstances);
- b. Acts to obtain possession of nonresidential real property when a lease has terminated;
- c. Setoff by swap participants and financial participants;
- d. Setoff and related actions in connection with certain securities, commodities and forward contracts;
- e. Actions by securities self regulatory organizations (e.g., stock exchanges such as NYSE and NASDAQ) to enforce regulatory powers; and
- f. Any transfer which is not avoidable under section 544, and not avoidable under section 549.<sup>71</sup>

Clearly, certain of these exceptions apply only to particularized entities or contexts, and are rather specialized policy exceptions, while others relate to purely ministerial acts which might otherwise fall within the scope of the stay. The latter two exceptions are new advents under BAPCPA. Each of these exceptions, as well as a few others, is described in more detail below. Exceptions to the stay should be narrowly construed to avoid the possibility of an inadvertent violation of the stay.<sup>72</sup>

#### 1. Perfection/Re-Perfection of Security Interests

Section 362(b)(3) permits the perfection, or the maintenance or continuation of perfection, of interests in property, under certain circumstances.<sup>73</sup> This can be broken down into two categories: (a) actions to obtain original perfection of an interest in property; and (b) actions to maintain or continue existing perfection. In the latter case, the policy for the exception is obvious: creditors with existing, validly perfected interests in the debtor's property should not be penalized, in the form of the loss of perfection, just because the deadline for the taking of action to continue perfection occurs during the pendency of the bankruptcy case.<sup>74</sup>

<sup>71</sup> See 11 U.S.C. § 362(b)(3), (6)-(7), (10), (17), (24) and (25).

<sup>72</sup> See *Treasurer of Snohomish Co. v. Seattle First Nat. Bank (In re Glasply Marine Industries, Inc.)*, 971 F.2d 391, 394-95 (9th Cir. 1992).

<sup>73</sup> See 11 U.S.C. § 362(b)(3).

<sup>74</sup> Some courts have also held that existing U.C.C. financing statements remains enforceable during the pendency of the bankruptcy case, thereby obviating the need to file a continuation statement during the pendency of the case. See, e.g., *In re Halmar Distributors, Inc.*, 968 F.2d 121, 127-28 (1st Cir. 1992); *General Electric*

In the case of original perfection, generally the exception applies if, under applicable nonbankruptcy law, a creditor is granted a grace period for the initial perfection of the creditor's interest in the property, and the grace period has not yet expired.<sup>75</sup> Under the Uniform Commercial Code, for example, a purchase money secured creditor has a 20-day grace period to perfect its security interest.<sup>76</sup> Perfection before the expiration of such grace period will relate back to the time of attachment, and is accordingly effective against an intervening lien creditor.<sup>77</sup> Section 362(b)(3) effectively acknowledges this "relation-back" provision by permitting the creditor to perfect during the grace period even though the bankruptcy case has been commenced.<sup>78</sup> The same general concept is applicable to statutory liens such as mechanics' and materialmen's liens, and where relation-back perfection requires the creditor to take possession of the collateral during the grace period, to avoid disruption to the debtor, the creditor need only file a notice of perfection pursuant to section 546(b) of the Bankruptcy Code.<sup>79</sup>

#### 2. Recovery of Nonresidential Real Property Subject to Lease

The automatic stay of does not apply to a lessor's efforts to retake possession of nonresidential real property after the expiration of the stated term of the lease.<sup>80</sup> Out of an abundance of caution, some lessors will seek relief from the stay before taking any action. In such instances, courts have held that expiration of the stated lease term (and even more broadly, the successful pre-petition termination of the lease), constitutes grounds for relief from the automatic stay to enable the lessor to retake the premises.<sup>81</sup>

It should be noted that this exception is limited to leases under which the stated term has expired, and

---

*Credit Corp. v. Nardulli & Sons, Inc.*, 836 F.2d 184, 189-90 (3d Cir. 1988). Of course, the safer approach is to nevertheless file a continuation statement with the relevant state authority.

<sup>75</sup> See, e.g., *Klein v. Cavale & Trovato, Inc. (In re Lionel Corp.)*, 29 F.3d 88, 93-94 (2d Cir. 1994) (notice and filing proof of service of mechanic's lien was excepted from stay.)

<sup>76</sup> See, e.g., Tex. Bus. & Com. Code § 9.324(a) (priority provision relating purchase money security interests).

<sup>77</sup> *Id.*

<sup>78</sup> See 11 U.S.C. § 362(b)(3) (cross-referencing §§ 547(b) and 547(e)(2)(A) of the Bankruptcy Code, which lay out limitations on avoidance actions and time limitations).

<sup>79</sup> See 11 U.S.C. § 546(b)(2).

<sup>80</sup> See 11 U.S.C. § 362(b)(10).

<sup>81</sup> See, e.g., *In re Salzer*, 52 F.3d 708, 713 (7th Cir. 1995).

does not apply to leases which are subject to early termination for other reasons. Only when the termination is based on expiration of the agreed term of the lease may the stay be safely disregarded.<sup>82</sup> In all other instances, a lessor should seek relief from the stay before taking any action.

### 3. Setoff of Swap Obligations, Securities, Commodities, and Forward Contracts

Section 362(b) also contains exceptions for offsets of mutual debts and claims by swap participant, commodities brokers, forward contract merchants, financial institutions, and financial participants, under or in connection with swap agreements, forward contracts, commodities contracts or margin payments.<sup>83</sup> Swap agreements include rate swap agreements, basis swap agreements, forward rate agreements, commodity swaps, interest rate options, forward foreign exchange agreements, spot foreign exchange agreements, rate cap agreements, rate floor agreements, rate collar agreements, currency swap agreements, cross-currency swap agreements, currency options, and any other similar agreements.<sup>84</sup> In general terms, because a swap agreement is, by its very nature, based upon the concept of setoff and netting, an exception to the stay is recognized. In addition, Congress has recognized the need to ensure that the financial markets continue to function smoothly in the face of a bankruptcy by a significant player within the markets.<sup>85</sup> These provisions have been especially meaningful to Enron's counter-parties in the Enron bankruptcy case given Enron's extensive involvement in the financial derivatives market.<sup>86</sup>

The rationale for the exception to continued regulatory actions by stock exchanges is similar and rather self-explanatory. It reflects a policy determination that these markets should not be unduly upset by the bankruptcy of a member.

### 4. Transfers Unavoidable Under Sections 544 and 549

The exception embodied in section 362(b)(24) of the Bankruptcy Code was, apparently, specifically implemented by BAPCPA to respond to a 1997 decision by the Ninth Circuit Court of Appeals involving a situation where, just after the

commencement of a bankruptcy case two purchase money lenders without notice thereof funded the debtor's acquisition of certain real property and recorded a corresponding mortgage.<sup>87</sup> The Court then held that the creation of the lien was a violation of the automatic stay, and therefore, void.<sup>88</sup> Accordingly, section 362(b)(24) provides that if a transfer is not avoidable under section 549 (unauthorized post-petition transfers) or section 544 (pre-petition transfers avoidable under applicable state or other nonbankruptcy law), it does not violate the stay.

### 5. Doctrine of Recoupment

Although recoupment is not among the express exceptions contained in section 362, its exception to the applicability of the stay is well established. Whereas a creditor's setoff of a pre-petition debt owing to the debtor against a claim against the debtor is stayed by the Bankruptcy Code, a creditor's defensive use of recoupment is not stayed.<sup>89</sup>

Recoupment is often confused with setoff. There are two factors which distinguish recoupment from setoff. First, recoupment is only a defense to collection of a debt – it may not be used affirmatively to seek collection of a debt (or the differential owing after setoff).<sup>90</sup> Second, recoupment requires mutuality of both the parties and the underlying indebtedness (or transaction), whereas setoff generally only requires mutuality as between the parties.<sup>91</sup>

There are two competing standards for determining whether there is mutuality of indebtedness. The first is the "logical relationship test," articulated in a 1926 Supreme Court decision.<sup>92</sup> The logical relationship test is a flexible test which generally requires only that the obligations be sufficiently connected such that it would be unjust to

<sup>82</sup> See 3 Collier's ¶ 362.05[10].

<sup>83</sup> See 11 U.S.C. §§ 362(b)(6)(7) and (17).

<sup>84</sup> See 11 U.S.C. § 101(53B).

<sup>85</sup> *Mirant Americas Energy Mktg., L.P. v. Kern Oil & Refining Co. (In re Mirant Corp.)*, 310 B.R. 548, 566-67 n. 29 (Bankr. N.D. Tex. 2004).

<sup>86</sup> See Robert Manor, *Critics: Probe 'Pretty Soft' on Enron Board*, Chicago Tribune, February 5, 2002.

<sup>87</sup> See Levin & Ranney-Marinelli, 79 Am. Bankr. L.J. at 634-35.

<sup>88</sup> *Id.* at 635 (Also explaining that the Court eventually withdrew the opinion and instead ruled on a wholly separate basis not implicating the automatic stay.)

<sup>89</sup> See 11 U.S.C. § 362(a)(7) (setoff stayed); *In re Midwest Serv. & Supply Co.*, 44 B.R. 262, 265 (Bankr. D. Utah 1983) (recoupment not stayed).

<sup>90</sup> See, e.g., *Chase County Gas Service Company, Inc.*, 1997 U.S. App. LEXIS 2359, at \*6 (10th Cir. 1997).

<sup>91</sup> See 5 Collier's ¶ 553.10; see also, e.g., *In re Mammoth Mart, Inc.*, 536 F.2d 950, 954 (2d Cir. 1976).

<sup>92</sup> See *Moore v. Cotton Exchange*, 270 U.S. 593, 610 (1926).

require one party to fulfill its obligations without requiring the other party to likewise perform.<sup>93</sup>

The second test finds its roots in the Third Circuit, and is known as the “integrated transaction test.” The integrated transaction test is much narrower, and generally requires that “the obligations in question ‘must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of the transaction without also meeting its obligations.’”<sup>94</sup> A leading treatise supports the broader test while recognizing that the majority trend is toward a more restrictive application.<sup>95</sup>

### C. Other Protections in Relation to Stay

#### 1. Preservation of Setoff Rights

Because setoff generally is precluded by the automatic stay, Congress has taken steps to ensure that setoff rights are protected in the bankruptcy case. Such protection is afforded by way of the allowance of a secured claim in the case to the extent of the setoff right. Pursuant to section 506(a) of the Bankruptcy Code, “[a]n allowed claim of a creditor...that is subject to setoff under section 553 of [the Bankruptcy Code], is a secured claim...to the extent of the amount subject to setoff...and is an unsecured claim to the extent that...the amount so subject to setoff is less than the amount of such allowed claim.”<sup>96</sup> In other words, a right to setoff operates as “collateral” for the creditor of its mutual claim against the debtor. Therefore, with respect to the secured claim of the creditor holding the right of setoff, the creditor is entitled to all of the protections afforded secured creditors under the Bankruptcy Code. Accordingly, although a creditor is stayed from exercising a valid setoff right by virtue of section 362, the creditor is entitled to “adequate protection” of its “collateral” during the course of the bankruptcy case, and may procure relief from the stay

or other forms of relief to protect against diminution in the value of its right of offset, as warranted.<sup>97</sup>

#### 2. Reclamation Rights

Section 546(c) protects a seller’s right to reclamation of goods under state law, and these protections were dramatically expanded under BAPCPA. Prior to BAPCPA, a seller seeking to effectuate a right of reclamation was required to fulfill the following conditions: (i) the seller must have a valid right of reclamation under state law or other nonbankruptcy law; (ii) the goods in question must have been sold in the ordinary course of the seller’s business; (iii) the debtor received the goods while insolvent; and (iv) the seller must make written demand for the goods before 10 days after their receipt by the debtor or, if the 10-day period expires after the commencement of the case, before 20 days after their receipt by the debtor.<sup>98</sup> Even if these requirements were met, the bankruptcy court could deny the request if it granted the seller an administrative expense priority claim or collateral securing it.<sup>99</sup>

Subsequent to the enactment of BAPCPA, the first requirement, that the right of reclamation exist under nonbankruptcy law, has been excised, and a right of reclamation now expressly applies to goods received by the debtor within 45 days prior to the commencement of the case.<sup>100</sup> The second and third requirements remain unchanged. As to the fourth requirement, the seller now has until the later of 45 days to assert its reclamation demand (rather than only 10), or, if the 45-day period expires after the commencement of the case, then 20 days after the commencement of the case, to assert its demand, and this is irrespective of when the goods were received by the debtor.<sup>101</sup> Finally, section 546(c)(2) now provides that, even if the seller fails to make a timely reclamation demand, the seller may still seek

<sup>93</sup> See, e.g., *Newberry Corp. v. Fireman’s Ins. Co.*, 95 F.3d 1392, 1402 (9th Cir. 1996); *Chase County Gas*, 1997 U.S. App. LEXIS 2359, at \*7 (purchases of gas treated as part of the same transaction despite multiple separate purchases under the contract.); *In re B&L Oil Co.*, 782 F.2d 155, 158 (10th Cir. 1986) (single contract generally qualifies for single transaction).

<sup>94</sup> See *In re University Medical Center*, 973 F.2d 1065, 1081 (3d Cir. 1992); 5 *Collier’s* ¶ 553.10[1].

<sup>95</sup> See 5 *Collier’s* ¶ 553.10[3]. See also Shalom L. Kohn, *Recoupment Re-Examined*, 73 Am. Bankr. L.J. 353, 360 (Spring 1999).

<sup>96</sup> 11 U.S.C. § 506(a).

<sup>97</sup> See 5 *Collier’s* ¶ 553.06[5]; *In re Olson*, 175 B.R. 30, 33 (Bankr. D. Neb. 1994).

<sup>98</sup> See 11 U.S.C. § 546(c) (2000).

<sup>99</sup> See 11 U.S.C. § 546(c)(2) (2000).

<sup>100</sup> 11 U.S.C. § 546(c). See also Levin & Ranney-Marinelli, 79 Am. Bankr. L.J. at 604-06 (explaining the ambiguity as to whether Congress intended to thereby create a federal right of reclamation).

<sup>101</sup> 11 U.S.C. § 546(c). Levin & Ranney-Marinelli, *supra* note 100, at 605. Although Levin and Ranney-Marinelli construe the language of the statute as allowing the seller to take advantage of whichever time frame expires later, additional ambiguity in the statute also supports a reading that, where the case is commenced during the pendency of the forty-five day period, the twenty day period running from the date of commencement then controls.

administrative priority for its corresponding claim, pursuant to section 503(b)(9).<sup>102</sup> In relation thereto, section 503(b)(9) confers administrative expense priority on any claim for the sale of goods in the ordinary course of the debtor's business which are received by the debtor within twenty (20) days prior to the commencement of the case.<sup>103</sup> Accordingly, even if a seller fails to timely assert its reclamation rights, it still holds substantial protections for the eventual repayment of its claim. The Bankruptcy Code, therefore, recognizes rights of reclamation beyond those recognized under state laws (the Uniform Commercial Code), because the priority is conferred irrespective of any nonbankruptcy law basis for a reclamation claim and even if the claimant fails to timely assert such rights. An obvious corresponding effect is to greatly increase the universe of priority claims with which a debtor must deal, and particularly for high inventory debtors regularly receiving such shipments.<sup>104</sup>

#### D. Relief from the Stay

Even though the stay is automatically imposed upon the filing of a debtor's bankruptcy case, it is plainly far from absolute. In addition to its exceptions, a creditor may, under appropriate circumstances, obtain relief from the stay by way of termination, annulment, modification, or a conditioning thereof. To obtain such relief, a creditor must file a motion in the bankruptcy case and provide notice to all of the major interested parties in the case.<sup>105</sup> The following bases for relief from the stay are expressly recognized in the Bankruptcy Code:

##### 1. "For Cause"

Section 362(d)(1) provides generally that relief from the stay may be granted "for cause, including lack of adequate protection of an interest in property of such party in interest."<sup>106</sup> Because of the fluid nature of the term "cause," a bankruptcy court has significant discretion in determining whether sufficient cause has been established under the circumstances involved.<sup>107</sup> The only example of "cause" expressly recognized

within the Bankruptcy Code is lack of adequate protection of an interest in property, which basis is separately addressed below. Other examples of where "cause" has been found to exist include: (i) the continuation of pending litigation against the debtor for the purpose of liquidating claims thereunder<sup>108</sup>; (ii) to provide comfort to creditors who seek relief from the stay as a precaution where the court finds that the stay does not prevent the proposed action (such as to continue divorce proceedings)<sup>109</sup>; (iii) failure to fulfill post-petition payment obligations required by the Bankruptcy Code or pursuant to order of the bankruptcy court<sup>110</sup>; and (iv) in the event of the debtor's bad faith use of the bankruptcy process.<sup>111</sup>

The first two examples and their rationales are rather straightforward. The third is closely related to the concept of adequate protection of creditors' interests in property addressed separately below. The fourth addresses perceived abuses of the bankruptcy process, such as to impede foreclosure or similar collection efforts with respect to real property liens.<sup>112</sup> This basis has recently been buttressed by BAPCPA's incorporation of a new subsection under section 362(d). Subsection (4) now provides that if the bankruptcy court finds that a petition was filed as "part of a scheme to hinder, delay or defraud creditors," and that such scheme involved either a transfer of ownership in the property absent the secured creditor's consent or multiple bankruptcy cases impacting the property, then the court will grant relief from the

<sup>108</sup> See, e.g., *In re Fowler*, 259 B.R. 856, 861 (Bankr. E.D. Tex. 2001); *In re Hakim*, 212 B.R. 632, 640 (Bankr. N.D. Ca. 1997).

<sup>109</sup> *Allen v. Allen (In re Allen)*, 275 F.3d 1160, 1162 (9th Cir. 2002) (bankruptcy court's failure to grant stay relief for cause was error where proposed action was, in fact, exempted from stay and cause requirement). Another example includes where the creditor seeks to recover on a claim against a co-debtor, not the debtor itself, on a claim that is related to (also owed by) the debtor. Because of the relationship to the debtor, the context may justify seeking relief from the stay even though the stay generally does not apply to nondebtors. See *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541, 547 (5th Cir. 1983) (automatic stay does not extend to non-debtor insurers and codefendants who may have some connection with the debtor).

<sup>110</sup> *Jones v. Money Store, Inc. (In re Jones)*, 284 B.R. 92, 98 (Bankr. E.D. Pa. 2002), *aff'd*, 308 B.R. 223 (E.D. Pa. 2003).

<sup>111</sup> *In re Reitnauer*, 152 F.3d 341, 344 n. 15 (5th Cir. 1998).

<sup>112</sup> See, e.g., *In re Lippolis*, 228 B.R. 106, 112 (E.D. Pa. 1998); *Green Point Bank v. Treston*, 188 B.R. 9, 12 (S.D.N.Y. 1995); *In re Citadel Props. Inc.*, 86 B.R. 275 (Bankr. M.D. Fla. 1988).

<sup>102</sup> Cf. 11 U.S.C. § 546(c)(2) (2000); and 11 U.S.C. § 546(c)(2) (2005).

<sup>103</sup> 11 U.S.C. § 503(b)(9).

<sup>104</sup> See Levin & Ranney-Marinelli, *supra* note 100, at 604-05.

<sup>105</sup> See generally Fed. R. Bankr. P. 4001(a).

<sup>106</sup> 11 U.S.C. § 362(d)(1).

<sup>107</sup> See *In re Countryside Manor, Inc.*, 188 B.R. 489, 490-91 (Bankr. D. Conn. 1995); *In re Sonnax Industries, Inc.*, 907 F.2d 1280, 1285-86 (2d Cir. 1990); H.R. Rep. No. 595, 95th Cong., 2d Sess. 343-44, *reprinted in* 1978 U.S. Code Cong. & Admin. News 6300.

stay.<sup>113</sup> Critically, to directly address the perceived problem of serial filings, this provision is further buttressed by additional language providing that any such order duly recorded in state real property lien records is generally binding in any subsequent bankruptcy case pertaining to the property that is commenced within two (2) years of the date of the order.<sup>114</sup>

## 2. Lack of Adequate Protection

As noted above, one of the bases for “cause” expressly enumerated in the Bankruptcy Code is the lack of adequate protection of a creditor’s interest in property. This basis normally relates to a secured creditor’s interest in collateral.<sup>115</sup> In fact, courts have generally held that the “interest in property” requirement limits the scope of this provision to security interests.<sup>116</sup> The Bankruptcy Code does not define the phrase “adequate protection.” However, lack of adequate protection is normally at issue where a secured creditor is undersecured and the collateral is depreciating in value due to the debtor’s continued use of it.<sup>117</sup> Another example of lack of adequate protection is where the debtor fails to maintain casualty insurance in relation to the collateral.<sup>118</sup>

Section 361 of the Bankruptcy Code sets out certain examples of how adequate protection may be provided by the debtor to secured creditor to avert

relief from the stay, including: (i) the making of periodic cash payments (to account for the diminution in value of the collateral); (ii) the giving of additional or replacement liens; (iii) the granting of an administrative priority claim in the bankruptcy case (the effect of which is to enable a secured creditor to realize the “indubitable equivalent” of the secured creditor’s secured claim to the extent that the secured nature of the claim is reduced through depreciation and the like).<sup>119</sup> Courts have also found that a secured creditor’s security interest/lien is adequately protected where there is a significant equity cushion in the collateral, casualty insurance is maintained, and the debtor agrees to provide the secured certain financial information on a regular basis.<sup>120</sup>

## 3. No Equity and Not Necessary

Relief from the automatic stay in relation to specific property may also be had where it shown that the debtor has no equity in such property and it is not necessary to the debtor’s reorganization.<sup>121</sup> Both elements of this test must be met; satisfaction of only one of the elements will not suffice.<sup>122</sup>

The first element may be shown where either (i) the property is encumbered by security interests/liens and, due to the property’s lack of value, there is no realistic residual interest left for the debtor’s, or (ii) the debtor (and therefore, its estate) does not, in fact, hold any equitable interest in the property irrespective of whether it may hold bare legal title (such as where the debtor holds property in trust).<sup>123</sup> In the first case, a secured creditor proceeding down the path of low valuation faces some risk on the back end as to payment on its secured claim. In particular, as explained below, a claim is only entitled to treatment (and, hence, distributions) as a secured claim to the extent of the creditor’s secured value in the collateral. Therefore, a secured creditor attempting to depress the value or valuation of its collateral for purposes of obtaining stay relief should expect a debtor/trustee to attempt to use the same valuation later in the case when it comes to determining the allowed amount of

<sup>113</sup> 11 U.S.C. § 362(d)(4)

<sup>114</sup> *Id.* The Debtor would have the opportunity to demonstrate to the latter court that circumstances have changed or other wise that good cause exists for relief from the prior order.

<sup>115</sup> *See, e.g., Treston, supra* note 112, at 12.

<sup>116</sup> *Cf. In re Aquarius Disk Servs.*, 254 B.R. 253, 260 (Bankr. N.D. Cal. 2000); *In re Leibowitz*, 147 B.R. 341, 345 (Bankr. S.D.N.Y. 1992) (only secured claims should be entitled to relief pursuant to section 362(d)(1) in the absence of extraordinary circumstances); *In re Offerman Farms, Inc.*, 67 B.R. 279, 282 (Bankr. D. Iowa 1986) (adequate protection is broader than the mere value of collateral); *In re Barkley-Cupit Enterprises, Inc.*, 13 B.R. 86, 92 (Bankr. N.D. Ga. 1981) (even in the absence of lien interests, a possessory interest is entitled to adequate protection).

<sup>117</sup> *See, e.g., United Sav. Asso. v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 369-71 (1988); *Bank of N.Y. v. Epic Resorts-Palm Springs Marquis Villas, LLC (In re Epic Capital Corp.)*, 290 B.R. 514, 526 (Bankr. D. Del. 2003); *In re Zeoli*, 249 B.R. 61, 63-64 (Bankr. S.D.N.Y. 2000)

<sup>118</sup> *See, e.g., Mendoza v. Temple-Inland Mortg. Corp. (In re Mendoza)*, 111 F.3d 1264, 1272 n. 3 (5th Cir. 1997); *Mitchell v. BankIllinois (In re Mitchell)*, 316 B.R. 891, 899 (S.D. Tex. 2003); *In re 5877 Poplar, L.P.*, 268 B.R. 140, 150 (Bankr. W.D. Tenn. 2001).

<sup>119</sup> *See* 11 U.S.C. § 361.

<sup>120</sup> *See* 3 *Collier's* ¶ 362.07[3].

<sup>121</sup> *See* 11 U.S.C. § 362(d)(2).

<sup>122</sup> *See In re Bennett Funding Group*, 255 B.R. 616, 638 (N.D.N.Y. 2000); *In re Lippolis*, 228 B.R. at 113; *In re Egea*, 167 B.R. 226, 230 (Bankr. D. Kan. 1994).

<sup>123</sup> *See In re Leonard*, 151 B.R. 639, 643 (Bankr. N.D.N.Y. 1992) (debtor lacks equity in property where the total sum of claims secured by the property exceeds its value); *In re Childress*, 182 B.R. 545, 554 (Bankr. D. Mo. 1995) (where debtors hold property in trust as bailees, debtors lack equity in such property).

the creditor's claim as a secured claim. Therefore, creditors should be cautious in proceeding down this path.<sup>124</sup>

In a Chapter 7 case, the second element of this test is automatically established, as there is no reorganization with respect to which the subject property could be essential. In a Chapter 11 case, on the other hand, the debtor has the burden of establishing that the property is necessary to reorganization.<sup>125</sup> Inherent in such requirement is that the debtor show that there is also a realistic possibility of reorganization overall within a reasonable period of time.<sup>126</sup>

#### 4. Single Asset Real Estate Cases

Congress has also established a separate basis for relief from the stay in single asset real estate cases. A single asset real estate case has the following characteristics: (i) there is real property constituting a single property or project (other than residential real property with fewer than 4 residential units); (ii) the real estates generates substantially all of the gross income of the debtor (other than a family farmer) and no substantial business is being conducted thereon by the debtor other than the business of operating the real property (and activities incidental).<sup>127</sup>

A creditor with a lien on such real estate is entitled to relief from the stay as to the property unless the debtor, by no later 90 days into the bankruptcy case (or 30 days from the date of a ruling by the bankruptcy court that the debtor is subject to this section, whichever is later): (i) files a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable period of time; and (ii) starts making monthly payments to each creditor with a lien against the property (other than a judgment lien or unmatured statutory lien), which payments are in an

amount equal to interest at the nondefault contract rate on the value of the creditor's lien in the property.<sup>128</sup>

The purpose of this provision is to address perceived abuses in such cases, in which debtors have attempted to delay mortgage foreclosures even when there is little chance that they can reorganize successfully.<sup>129</sup> Of course, irrespective of the responsive protections afforded by section 362(d)(3), the court may grant relief under section 362(d)(1) or (d)(2) as appropriate, and even if the time period set forth in section 362(d)(3) has not run.

#### IV. CASH COLLATERAL

Another primary issue in business bankruptcies that arises immediately upon the commencement of a Chapter 11 case relates to the debtor's use of "cash collateral." Bankruptcy is often brought about by a loss in liquidity or a cash crisis. Obviously, without sufficient cash flow, a business has little chance for survival either in or out of bankruptcy. Without cash, for example, a debtor cannot realistically compensate its workforce, purchase supplies and inventory, and pay for other necessary services (including legal advice). "Cash is king" is often a term heard in the context of bankruptcy.

Creditors having security interests in cash or cash equivalents (often as proceeds of collateral) are in a particularly troublesome spot when it comes a debtor's continuing use of cash, especially given the fact that it is totally liquid and transferable, and that it is often commingled with other unencumbered cash making it difficult, if not impossible, for the secured creditor to trace its security interest to any particular pool of cash. Moreover, even where a creditor's collateral is not so fungible as cash, that collateral may nevertheless produce additional collateral (as proceeds, such as rent) in the form of cash equivalents. This ongoing cash generated from the collateral of a creditor is commonly referred to as "cash collateral." As a result of these, and other, factors, Congress has established special provisions and protections in the Bankruptcy Code to protect secured creditors' interests in cash and cash equivalents.

<sup>124</sup> See 3 *Collier's* ¶ 362.07[4] (noting, however, that a prior finding in the adequate protection context will not automatically carry *res judicata* or collateral estoppel effect in relation to a different, subsequent dispute).

<sup>125</sup> *In re Sutton*, 904 F.2d 327, 330 (5th Cir. 1990); *In re Diplomat Electronics Corp.*, 82 B.R. 688, 693 (Bankr. S.D.N.Y. 1988)

<sup>126</sup> See *Sutton*, supra note 125, at 330.

<sup>127</sup> 11 U.S.C. § 101(51B). Prior to BAPCPA, the definition also included a requirement that the debtor have aggregate noncontingent, liquidated secured debts in an amount of no more than \$4 million.

<sup>128</sup> See 11 U.S.C. § 362(d)(3). BAPCPA has also clarified that such payments may be made from pre-petition or post-petition rental proceeds of the property, at the debtor's discretion. See also generally 3 *Collier's* ¶ 362.07[5].

<sup>129</sup> Compare the rationale discussed for section 362(d)(4) addressed above.

### A. Cash Collateral” Defined

“Cash collateral” is defined in the Bankruptcy Code as “cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property...whether existing before or after the commencement of a case under [the Bankruptcy Code].”<sup>130</sup>

### B. Limitations on Use

Pursuant to section 363 of the Bankruptcy Code, a debtor’s ability to use cash collateral is significantly restricted. Additionally, the Bankruptcy Code requires segregation of cash collateral to protect against commingling and the debtor’s inadvertent use of cash collateral, and to enable an accounting of all cash collateral during the course of the bankruptcy case. Each of these areas is separately addressed below.

#### 1. Consent v. Court Authorization

Pursuant to section 363 of the Bankruptcy Code, a debtor may only use cash collateral if (i) the debtor obtains the consent of each creditor having a security interest in the cash collateral, or (ii) the bankruptcy court, after notice and an opportunity for hearing, authorizes the debtor’s use of the cash collateral.<sup>131</sup> Additionally, if the debtor’s proposed use of cash collateral is in connection with a transaction which is out of the ordinary course of the debtor’s business, then the debtor must also first obtain approval to enter into the transaction itself.<sup>132</sup>

Due to the leverage conferred upon secured creditors, their unqualified consent is rarely given.<sup>133</sup> Consent, if granted, is often conditioned upon one or more (and usually all or substantially all) of the following requirements:

- a. Replacement liens on unencumbered property (usually accounts receivable) to protect against diminution in value;
- b. The granting of an administrative priority claim in the case to the extent that the secured creditor’s secured claim is reduced

through the debtor’s use of cash collateral (and any replacement liens in collateral prove to be insufficient);

- c. Periodic payments to the secured creditor, and/or the allocation of a certain percentage of sales proceeds generated from sale of collateral to the secured creditor;
- d. Automatic lift stay provisions in the event of default under the cash collateral agreement;
- e. Cash collateral budgets which are subject to approval of the secured creditor;
- f. Periodic financial reporting by the debtor; and
- g. Performance milestones and case deadlines;
- h. Stipulation by the debtor to the extent, validity and priority of the secured creditor’s security interests and liens, and a limited period for attack by other interested parties in the Bankruptcy Case.<sup>134</sup>

An agreement with the debtor containing such conditions is subject to bankruptcy court approval, and requires that notice and an opportunity to object be given to all essential interested parties in the Bankruptcy Case.<sup>135</sup> If consent is not given, then the debtor’s use of cash collateral must be approved by the bankruptcy court over the creditor’s objection. The key objection to use of cash collateral is lack of adequate protection of the secured creditor’s interest in the collateral.<sup>136</sup>

#### 2. Sales

The “use” of collateral and cash collateral by a bankruptcy estate often involves the sale of such property, and accordingly, section 363 incorporates specific provisions assisting the court in evaluating requests for the approval of proposed sales over the objections of creditors holding interests in such property. Specifically, section 363(f) provides that the bankruptcy estate may sell property free and clear of any such interest only if:

- (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

<sup>130</sup> 11 U.S.C. § 363(a).

<sup>131</sup> See 11 U.S.C. § 363(c)(2).

<sup>132</sup> See 11 U.S.C. § 363(b). BAPCPA has incorporated additional provisions in this section for the preservation and protection of pre-petition policies of the debtor respecting the privacy of an individual’s personally identifiable information.

<sup>133</sup> George W. Kuney, *Hijacking Chapter 11*, 21 Bank. Dev. J. 19, 81 (2004).

<sup>134</sup> See Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 Am. Bankr. L.J. 153, 182 (Spring 2004).

<sup>135</sup> See *Northview Motors, Inc. v. Chrysler Motors Corp.*, 186 F.3d 346, 350 (3d Cir. 1999); Fed. R. Bankr. P. 4001(d).

<sup>136</sup> See 11 U.S.C. § 363(e). For an in-depth discussion of the substantive considerations relevant to this issue, also see the discussion set forth above in III.D regarding issues involving adequate protection.

- (2) such entity consents;
- (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
- (4) such interest is in bona fide dispute; or
- (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.<sup>137</sup>

### 3. Required Segregation of Cash Collateral

Among other things, the Bankruptcy Code also requires the debtor/trustee to segregate and account for all cash collateral in the debtor's/trustee's possession, custody, or control.<sup>138</sup> As stated previously, this mandate is designed to provide some limited protection to creditors with a security interest in cash collateral. Failure of a debtor to comply with such obligations may result in remedial measures in favor of the injured creditor (such as replacement liens or super-priority claims), sanctions against the debtor, and may also serve as grounds for appointment of a trustee and/or conversion of a Chapter 11 case to Chapter 7.<sup>139</sup>

## V. EXECUTORY CONTRACTS AND UNEXPIRED LEASES

### A. Overview of Section 365 of Code

Often a contributing factor to a debtor's downfall is the inability of the debtor to renegotiate or get out of long-term contracts and leases which are creating a drag on the business due to changes within the industry (e.g., pricing) or the debtor's non-utilization of the benefits provided under the contracts/leases. Suppose, for example, the debtor enters into a 10-year office lease in Dallas, Texas in anticipation of opening a line of business in Texas. If the debtor subsequently determines that Texas is not where the company wants to go, the debtor is still stuck with an expensive long-term lease unless the debtor is able to negotiate an assignment of the lease or an early termination with the landlord. Alternatively, suppose the debtor, a manufacturer of housing products, enters into a 10-year contract for the purchase of a set quantity of insulation materials per month at a set price. Thereafter, a new insulation product is introduced into the marketplace which proves to be more effective, and the debtor's customers decide that they will only buy the debtor's housing products if they contain the new insulation

material. The debtor is stuck in a Catch 22 position – in order to keep its customers, it must begin purchasing the new insulation; in order to avoid losses under the 10-year contract, the debtor must continue to use the old insurance product. The only way out is to find an assignee of the 10-year contract or negotiate an early termination of the contract – neither of which may be available.

The Bankruptcy Code contains certain provisions on executory contracts which enable the debtor to address these problems. Under section 365 a debtor may, for example, reject onerous contracts and leases (an act which constitutes breach of the contract/lease) and treat the rejection (breach) damages as part of the overall pool of pre-petition, unsecured claims (thus enabling the debtor to satisfy them through pro-rata distributions).

#### 1. "Executory" Defined

Although what precisely makes a particular contract "executory" is not expressly defined in the Bankruptcy Code, the most widely accepted definition of an executory contract is one under which the "obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."<sup>140</sup> Moreover, although "executoriness" is a matter that is viewed as of the bankruptcy petition date, it is possible for post-petition events to impact these issues, such as where a contract was executory when the case was commenced but expires under its own terms early in the case.<sup>141</sup> In this situation, there would be no purpose in either rejecting the contract, because there would be no additional damages or obligations to resolve, or assuming it, because there would be no remaining benefit to be obtained.

Furthermore, despite its popularity, the Countryman definition leaves open certain issues, and has not gone unchallenged.<sup>142</sup> The definition itself

<sup>137</sup> 11 U.S.C. § 363(f).

<sup>138</sup> See 11 U.S.C. § 363(c)(4).

<sup>139</sup> See Harley J. Goldstein & Craig A. Sloane, *Spending Other People's Money: Creditors' Remedies for the Misuse of Cash Collateral in Bankruptcy*, 7 U. Miami Bus. L. Rev. 243, 249-270 (Spring 1999).

<sup>140</sup> Vern Countryman, *Executory Contracts in Bankruptcy*, Part I, 57 Minn. L. Rev. 439, 460 (1973). This is commonly referred to as the Countryman, or "material breach," definition. Unexpired leases occasion far less discourse over their definition. Other than with respect to such definitional issues, any discussion hereinafter of executory contracts applies equally to unexpired leases, unless otherwise indicated.

<sup>141</sup> See *In re Spectrum Info. Techs.*, 193 B.R. 400, 404 (Bankr. E.D.N.Y. 1996).

<sup>142</sup> *Cohen v. Drexel Burnham Lambert Group*, 138 B.R. 687, 709 (Bankr. S.D.N.Y. 1992) (Departing from the Countryman definition in favor of a functional approach focused on benefit to the estate). The "functional

incorporates the concept of a material breach, such that materiality (the significance of the relevant obligations) becomes an issue.<sup>143</sup> In addition, the construction of a contract in bankruptcy is subject to the same considerations influencing how the transaction is viewed and interpreted under applicable state law.<sup>144</sup> For example, one condition for the estate's assumption of an executory contract is that the contract must be treated in its entirety: the debtor may not assume favorable provisions while rejecting unfavorable ones.<sup>145</sup> However, irrespective of how a single contract or lease document is drafted or labeled, such document may be held to actually constitute several separate agreements.<sup>146</sup> If a single contract contains separate, severable agreements, each of which may or may not be executory, they may likewise be treated separately by the debtor.<sup>147</sup>

## 2. Ipsa Facto Clauses Unenforceable

Whereas a debtor may wish to get out of certain contracts and leases, other contracts/leases are critical to the debtor's ongoing operations and/or may have significant value for the purposes of assignment to a third party due to their terms. Needless to say, a debtor's bankruptcy filing is generally perceived to be a negative revelation to the non-debtor contracting party, and this gives rise to provisions in contracts

---

approach" embodies a result oriented policy in favor of broadly construing "executoriness" of contracts in bankruptcy.

<sup>143</sup> See, e.g., *In re Spectrum Technologies, Inc.*, 190 B.R. 741, 747 (Bankr. E.D.N.Y. 1996) (explaining that the payment of money is an obligation insufficient by itself to render a contract executory). Cf. *In re Andrews*, 80 F.3d 906, 914 (4th Cir. 1996) (payment of money and non-compete obligations render contract clearly executory).

<sup>144</sup> See, e.g., *Duke Energy Royal, LLC v. Pillowtex Corp. (In re Pillowtex, Inc.)*, 349 F.3d 711, 716 (3d Cir. 2003); *In re Smith*, 262 B.R. 365, 370 (Bankr. E.D. Va. 2000). See also *Cameron v. Pfaff Plumbing & Heating, Inc.*, 966 F.2d 414, 416 (8th Cir. 1992) (holding that "executoriness" under section 365 is a matter of federal law, but acknowledging the relevance of state law in rendering such analysis.).

<sup>145</sup> See, e.g., *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1311 (5th Cir. 1985); *In re University Medical Center*, 973 F.2d at 1075; *AGV Productions v. MGM*, 115 F. Supp.2d 378, 390-91 (S.D.N.Y. 2000).

<sup>146</sup> See *In re Gardinier, Inc.*, 831 F.2d 974, 976-77 (11th Cir. 1987).

<sup>147</sup> *Stewart Title Guar. Co. v. Old Republic Nat. Title Ins. Co.*, 83 F.3d 735, 740-41 (5th Cir. 1996). Conversely, multiple instruments may be interpreted as a single, indivisible contract, thus requiring the debtor to treat them accordingly. See *In re Atlantic Computer Systems, Inc.*, 173 B.R. 844, 849 (S.D.N.Y. 1994).

calling for the immediate termination of the contract upon insolvency and/or bankruptcy.<sup>148</sup> Pursuant to section 365 of the Bankruptcy Code, these *ipso facto* clauses are generally deemed to be unenforceable.

In particular, section 365(e) provides that "[n]otwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on – (A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under [the Bankruptcy Code]; or (C) the appointment of or taking possession by a trustee in a case under [the Bankruptcy Code] or a custodian before such commencement."<sup>149</sup>

A few exceptions to this rule are recognized. First, if applicable non-bankruptcy law excuses the non-debtor from accepting performance from or rendering performance to the debtor/trustee, or to an assignee of such contract/lease, then the *ipso facto* clause is enforceable.<sup>150</sup> Second, if the contract is a financial accommodations contract (e.g., an agreement to make a loan), then the *ipso facto* clause is enforceable.<sup>151</sup>

The apparent conflict between sections 365(f) and sections 365(c) and (e)(2) has occasioned much debate. On the one hand, subsection (f) invalidates any provision in an agreement or applicable law that prohibits or restricts assignments, whereas subsections (c) and (e)(2) provide that if applicable law excuses the nondebtor party from accepting performance by another entity, then such provision remains effective and the contract may not be assumed or assigned.<sup>152</sup> This apparent tension has led one Court to explain that:

---

<sup>148</sup> See *Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238, 240 n. 1 (5th Cir. 2006).

<sup>149</sup> 11 U.S.C. § 365(e)(1). See also *Bonneville v. Mirant, supra* note 148, at 245. Section 365(f) contains a similar provision invalidating restrictions on the assignability of contracts in order to support the estate's ability to maximize the value of its contracts to potential assignees.

<sup>150</sup> See 11 U.S.C. § 365(c) and (e)(2).

<sup>151</sup> See 11 U.S.C. § 365(e)(2).

<sup>152</sup> This tension gives rise to a further dispute over whether, if such provisions remain effective, they bar both the attempted assumption and assignment of a contract or merely the assignment to another entity but not its

§ 365(f)(1) states the general rule that a trustee or debtor in possession may assign an executory contract notwithstanding 'applicable law' that prohibits assignment, while § 365(c)(1)(A) represents an exception to that rule where applicable law protects the right of the non-debtor contracting party to refuse to accept from or render performance to an assignee, and does not apply to general prohibitions on assignments.<sup>153</sup>

Thus, the distinction is between a law that generally prohibits assignment and law that excuses performance – if the law excuses performance, section 365(c)(1) applies notwithstanding section 365(f).<sup>154</sup> This holding agrees with the majority of opinions that have addressed the interplay between these two sections.<sup>155</sup>

## B. Assumption or Rejection

The debtor/trustee must obtain approval from the bankruptcy court to assume or reject a contract/lease.<sup>156</sup> Generally, a debtor's/trustee's

---

assumption by the estate. See *Bonneville v. Mirant*, *supra* note 148, at 247-51 (also explaining the competing "hypothetical" (assumption and assignment prohibited) and "actual" (only assignment prohibited) tests, and rejecting hypothetical test in favor of actual test.).

<sup>153</sup> *In re Lil' Things Inc.*, 220 B.R. 583, 591 (Bankr. N.D. Tex. 1998). *But see Everex Sys. Inc. v. Cadtrack Corp. (In re CFLC Inc.)*, 89 F.3d 673, 676-77 (9th Cir. 1996)(explaining the relevant distinction as being whether the "applicable law" prohibits assignment where the contract specifically does so (laws enforcing such provisions), or prohibits assignments even if the contract is silent).

<sup>154</sup> Examples of such applicable law excusing performance would be patent law and other laws applicable to contracts for personal services (those relating to the particular identity of the contracting party, such as commissions for artistic works). See, e.g., *Everex v. Cadtrack*, *supra* note 153, at 677, 679; *In re Patient Educ. Media Inc.*, 210 B.R. 237, 242 (Bankr. S.D.N.Y. 1997)(copyright).

<sup>155</sup> See *City of Jamestown v. James Cable Partners L.P. (In re James Cable Partners L.P.)*, 27 F.3d 534, 538 (11th Cir. 1994) ("the 'applicable law' to which subsection (c) refers must mean 'applicable law' other than general prohibitions barring assignment"); *Rieser v. Dayton Country Club Co. (In re Magness)*, 972 F.2d 689, 696 (6th Cir. 1992) ("the applicable law...addresses the interests of the non-debtor third parties, rather than law relating to general prohibitions or restrictions on assignment of executory contracts covered by § 365(f)").

<sup>156</sup> See *In re Kmart Corp.*, 2006 Bankr. LEXIS 542, \*116 (Bankr. N.D. Ill. 2006); 11 U.S.C. § 365(a).

determination is evaluated under a "business judgment rule" standard.<sup>157</sup>

### 1. Impact of Rejection

Rejection of an executory contract/unexpired lease constitutes a material breach of the contract/lease, entitling the non-debtor, non-breaching party to damages.<sup>158</sup> Although rejection results in a breach, it does not necessarily terminate the contract.<sup>159</sup> The breach is deemed to have occurred, however, immediately before the date of the filing of the bankruptcy case.<sup>160</sup> Consequently, any breach damages will be treated as a pre-petition claim subject to administration in the bankruptcy case along with all other pre-petition claims.<sup>161</sup>

Of significance, the Bankruptcy Code caps certain types of rejection damage claims. For example, a real estate lessor's rejection claim is capped at an amount equal to all rent reserved under the lease (without acceleration) for the greater of 1 year, or 15% (but not to exceed 3 years), of the remaining term of the lease.<sup>162</sup> The Bankruptcy Code also limits employees' claims stemming from the rejection of long-term employment contracts by providing for the disallowance of all amounts in excess of the amount payable thereunder for 1 year.<sup>163</sup>

Finally, the Bankruptcy Code sets out special protections a limited number of nondebtor parties in the face of a debtor's/trustee's rejection of certain types of contracts and leases, designed to protect parties who face significant harm in the face of a rejection. Such parties include: (i) lessees of real property<sup>164</sup>; (ii) purchasers of realty and timeshare

---

<sup>157</sup> *Official Comm. of Unsecured Creditors of Mirant Corp. v. Potomac Elec. Power Co. (In re Mirant Corp.)*, 378 F.3d 511, 524 n. 5 (5th Cir. 2004), *aff'd*, 197 Fed.Appx. 285 (5th Cir. 2006); *In re Federated Dep't Stores, Inc.*, 131 B.R. 808, 812 (S.D. Ohio 1991).

<sup>158</sup> 11 U.S.C. § 365(g).

<sup>159</sup> See *Stoltz v. Brattleboro Hous. Auth. (In re Stoltz)*, 315 F.3d 80, 86 (2d Cir. 2002); *Foothill Capital Corp. v. Official Unsecured Creditors' Comm. of Midcom Commun.*, 246 B.R. 296, 301-02 (E.D. Mich. 2000).

<sup>160</sup> *In re AppliedTheory Corp.*, 312 B.R. 225, 235 (Bankr. S.D.N.Y. 2004); 11 U.S.C. § 365(g)(1).

<sup>161</sup> See *Foothill v. Official Unsecured Creditors' Comm. of Midcom Commun.*, *supra* note 159, at 304 n. 19 (E.D. Mich. 2000); 11 U.S.C. § 502(g).

<sup>162</sup> See *Solow v. PPI Enters. (In re PPI Enters.)*, 324 F.3d 197, 207-08 (3d Cir. 2003); 11 U.S.C. § 502(b)(6).

<sup>163</sup> See *Young v. Condor Sys. (In re Condor Sys.)*, 296 B.R. 5, 12, 15 (9th Cir. B.A.P. 2003); 11 U.S.C. § 502(b)(7).

<sup>164</sup> 11 U.S.C. § 365(h)(1).

interests<sup>165</sup>; and (iii) licensees of intellectual property.<sup>166</sup>

## 2. Requirements for Assumption / Assignment

Because the assumption of an executory contract requires the debtor to take the burdens with the benefits, the debtor may only assume a contract if the following requirements are met:

- a. The debtor/trustee cures, or provides adequate assurance that the defaults will promptly be cured;
- b. The debtor/trustee compensates, or provides adequate assurance of prompt compensation of, the non-debtor party to such contract/lease for any actual pecuniary loss resulting from the default; and
- c. The debtor/trustee provides adequate assurance of future performance under such contract/lease.<sup>167</sup>

Adequate assurance of future performance generally requires proof that the debtor/trustee will have the financial wherewithal, all necessary resources (e.g. necessary equipment, as applicable), and expertise (as applicable) to perform going forward.<sup>168</sup>

Furthermore, as noted, a chief benefit to the assumption of contracts by the estate is the ability to assign the contract to a third party either for value or to mitigate damages. Specifically, to obtain bankruptcy court approval for such an assignment, the following requirements must be met:

- d. The debtor/trustee must assume the contract/lease (subject to the requirements

set out above in the event there is an existing default); and

- e. The debtor/trustee must establish that there is adequate assurance of future performance by the assignee of the contract/lease (whether or not there is an existing default).<sup>169</sup>

The debtor must also navigate the provisions of section 365(c), (e)(2) and (f) discussed hereinabove.

## C. Time Limitations and Payment Requirements

Certain time limitations are applicable to assumption and rejection. In a Chapter 7 case, the trustee must move to assume an executory contract or unexpired lease by no later than 60 days after the order for relief (which is the same date as the date of the bankruptcy filing in a voluntary bankruptcy case), in the absence of which the contract/lease is deemed rejected.<sup>170</sup> If cause is shown by the trustee on motion, the period may be extended by the bankruptcy court.<sup>171</sup>

In a Chapter 11 case, on the other hand, the debtor/trustee has until the time of confirmation of a plan to move for assumption of executory contracts and leases of residential real property and personal property.<sup>172</sup> However, as a further protection to commercial landlords, section 365(d)(4) provides for the deemed rejection of unexpired nonresidential real property leases under which the debtor is the lessee, on “the earlier of -- (i) the date that is 120 days after the date of the order for relief; or (ii) the date of the entry of an order confirming a plan.”<sup>173</sup> Although the bankruptcy court, on the motion of the debtor, trustee or lessor for cause, may still extend such deadline for 90 days prior to the expiration of the 120-day period, the Bankruptcy Code expressly states that this deadline may not thereafter be extended again absent the lessor’s prior written consent.<sup>174</sup> Also to prevent serious hardship to non-debtor parties to such executory contracts and unexpired leases, the Bankruptcy Code further provides that the bankruptcy court may shorten these deadlines under appropriate circumstances.<sup>175</sup>

<sup>165</sup> 11 U.S.C. §§ 365(h)(2), (i)-(j).

<sup>166</sup> 11 U.S.C. § 365(n).

<sup>167</sup> See *In re PRK Enters., Inc.*, 235 B.R. 597, 600-03 (Bankr. E.D. Tex. 1999); 11 U.S.C. § 365(b)(1). BAPCPA has expressly negated any obligation to cure non-monetary defaults if it is impossible to do so by performing nonmonetary acts, provided however, that “if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph...” 11 U.S.C. § 365(b)(1)(A).

<sup>168</sup> See *Tex. Health Enters. v. Lytle Nursing Home (In re Tex. Health Enters.)*, 72 Fed. Appx. 122, 126 (5th Cir. 2003); *Lifemark Hospitals, Inc. v. Liljeberg Enters. (In re Liljeberg Enters.)*, 304 F.3d 410, 438-439 (5th Cir. 2002):

<sup>169</sup> 11 U.S.C. § 365(f)(2).

<sup>170</sup> 11 U.S.C. § 365(d)(1).

<sup>171</sup> *Id.*

<sup>172</sup> See 11 U.S.C. § 365(d)(2).

<sup>173</sup> 11 U.S.C. § 365(d)(4). This provision was implemented via BAPCPA.

<sup>174</sup> See also *Levin & Ranney-Marinelli*, 79 Am. Bankr. L.J. at 623-24.

<sup>175</sup> 11 U.S.C. § 365(d)(2). In deciding what constitutes a reasonable time for the debtor/trustee to make its

To minimize the burden on nondebtor parties to certain executory contracts while the debtor/trustee is analyzing whether to assume or reject, the Bankruptcy Code sets out certain performance requirements. In relation to nonresidential real property leases, the debtor/trustee must timely perform all obligations under the lease which arise from and after the order for relief until the lease is assumed or rejected.<sup>176</sup> For cause shown, however, the time for performing such obligations may be extended, but not beyond 60 days after the order for relief.<sup>177</sup> Similarly, as to leases of personal property, the debtor/trustee is required to perform all obligations under the lease arising from and after 60 days from the date of the order for relief until the lease is assumed or rejected.<sup>178</sup> However, again, the bankruptcy court has the authority to adjust the time for performance of such obligations where cause is shown, and also has the authority to modify the obligations which must be performed if a reasonable justification for the modification is shown.

Under section 503(b), the bankruptcy court may allow an administrative expense priority claim (having the highest priority of all unsecured claims) for “actual, necessary costs and expenses of preserving the estate...”<sup>179</sup> However, in the event that the debtor fails to fulfill these obligations required for timely performance under section 365, the lessor is generally granted an administrative expense claim for such

amounts without any need to demonstrate the usual element of benefit to the estate.<sup>180</sup>

## VI. EVIDENCING PRE-PETITION CLAIMS IN THE CASE

In order to be eligible to receive distributions from the bankruptcy estate, a creditor generally must file proof of its pre-petition claim, to the extent that a debtor has failed to unqualifiedly list the claim independently in court papers.<sup>181</sup> Moreover, in every case (other than a Chapter 7 case designated as a “no asset” case) a “bar date” is set establishing a deadline for the filing of claims.<sup>182</sup> Failure to file a proof of claim by the bar date can be fatal to allowance of the claim in the case absent lack of due process (i.e. notice or actual knowledge).<sup>183</sup> In order for a proof of claim to be valid, it must be in writing, set forth the creditor’s claim in reasonable detail, be executed by the creditor or an authorized agent, and have attached to it all appropriate supporting documents.<sup>184</sup> Of course, even after the proof of claim is filed, the claim is subject to objection. However, a properly completed, executed, and supported proof of claim will constitute *prima facie* evidence of the validity and amount of the claim, which transfers the burden to others to dispute it.<sup>185</sup>

### A. Debtor’s Schedules v. Proof of Claim

Shortly after a bankruptcy case is filed, the debtor is required to file a set of schedules setting out, among other things, a listing of all known pre-petition claims against it.<sup>186</sup> The requirement is expansive, requiring the debtor to schedule even unliquidated, contingent

---

determination, courts consider several factors, including: (i) the damage that the non-debtor will suffer beyond the compensation available under the Bankruptcy Code; (ii) the primacy of the contract to the debtor’s business and reorganization, such as whether the executory contract is a primary asset; (iii) whether the debtor has had sufficient time to appraise its financial situation and the potential value of its assets in formulating a plan of reorganization; (iv) whether plan exclusivity (addressed below) has terminated; (v) the complexity of the case; (vi) the number of executory contracts and unexpired leases; (vii) the need for a judicial determination as to whether an executory contract actually exists; (viii) safeguards afforded to the litigants; and (ix) any failure to satisfy post-petition obligations. See *South Street Seaport Limited Partnership v. Burger Boys, Inc.* (In re *Burger Boys, Inc.*), 94 F.3d 755, 761 (2d Cir. 1996); *In re Adelpia Communs. Corp.*, 291 B.R. 283, 293 (Bankr. S.D.N.Y. 2003); *In re Enron Corp.*, 279 B.R. 695, 702 (Bankr. S.D.N.Y. 2002).

<sup>176</sup> 11 U.S.C. § 365(d)(3).

<sup>177</sup> *Id.*

<sup>178</sup> 11 U.S.C. § 365(d)(5).

<sup>179</sup> See 11 U.S.C. § 503(b)(1)(A).

---

<sup>180</sup> See, e.g., *Thinking Machs. Corp. v. Mellon Fin. Servs. Corp.* (In re *Thinking Machs. Corp.*), 67 F.3d 1021, 1024 (1st Cir. 1995); *Augusta Mall Pshp. v. Twigland Fashions* (In re *Twigland Fashions*), 198 B.R. 199, 200 (W.D. Tex. 1996); *In re Pudgie’s Dev. of NY, Inc.*, 202 BR 832, 834-36 (Bankr. S.D.N.Y. 1996). But see *In re Orvco, Inc.*, 95 B.R. 724, 727, 728 (9th Cir. B.A.P. 1989); *In re Tammey Jewels, Inc.*, 116 B.R. 292, 294 (Bankr. M.D. Fla. 1990).

<sup>181</sup> The proof of claim form utilized for such purpose is a brief one page form available from most bankruptcy court websites.

<sup>182</sup> These considerations are irrelevant to Chapter 7 “no-asset” cases because there will be no distributions thereunder so long as there are no assets from which to make them.

<sup>183</sup> See 11 U.S.C. § 502(b)(9) (late-filed claims are generally disallowed in full).

<sup>184</sup> See Fed. R. Bankr. P. 3001(a)-(d).

<sup>185</sup> See Fed. R. Bankr. P. 3001(f).

<sup>186</sup> See 11 U.S.C. § 521(a)(1); Fed. R. Bankr. P. 1007.

and disputed claims.<sup>187</sup> Because a debtor is required to affirm the schedules under oath, the schedules have the effect of an admission by the debtor to the claims' validity, priority and amount, unless designated as unliquidated, contingent or disputed.<sup>188</sup> Thus, if a creditor agrees with the listed amount and priority of its claim in the debtor's schedules, then there is usually no need for the creditor to independently file a proof of claim.<sup>189</sup> The safer approach, however, is to always file a proof of claim. In addition to possible errors in the schedules, there is also the possibility that the debtor will later amend its schedules to eliminate, modify or otherwise recharacterize the claim.<sup>190</sup> At a minimum, if a claim is listed by the debtor as unliquidated, contingent or disputed, then the filing of a proof of claim becomes critical because the scheduled claim essentially carries no evidentiary value.

### B. Timing for Filing

Within 20 to 40 days after a bankruptcy case is filed, the Office of the United States Trustee will conduct a meeting of creditors, often referred to as the "341 meeting" based upon provisions within section 341 of the Bankruptcy Code.<sup>191</sup> A representative of the United States Trustee's Office presides over the meeting, at which a representative of the debtor is required to be present to answer questions under oath. The 341 meeting is not only important for purposes of learning about the debtor's business, reasons for filing for bankruptcy, and the debtor's overall assets and debt structure, but also for purposes of setting a bench mark date from which certain proof of claim filing deadlines run.

In Chapter 7 cases, for example, the deadline for filing proofs of claim is 90 days from the date of the 341 meeting.<sup>192</sup> In Chapter 11 cases, the bar date is independently established by the bankruptcy court.<sup>193</sup> It is not uncommon, however, for bankruptcy courts to establish the same 90 day deadline in Chapter 11 cases

pursuant to the courts' local rules, subject to the ability to modify the deadline upon motion.<sup>194</sup>

If a creditor misses the proof of claim bar date, all is not lost. There are two primary avenues under which a creditor may seek the allowance of a tardy filed claim. As a matter of due process, where a creditor does not receive reasonable notice of a bankruptcy case sufficient to allow it to meet the bar date, its claim cannot be barred for untimeliness.<sup>195</sup> In addition, Bankruptcy Rule 9006(b)(1) incorporates an "excusable neglect" standard that contemplates that courts may, in their discretion, accept late filings where the failure to timely file is caused by inadvertence, mistake or carelessness, as well as by circumstances beyond the party's control.<sup>196</sup>

### C. Secured Claims

Claims secured by security interests and liens receive very particular treatment under the Bankruptcy Code. In 1971, the Supreme Court emphasized that, unless some federal interest requires a different result, a bankruptcy proceeding should not impact property rights created under applicable state law.<sup>197</sup> Many courts have even gone so far as to rule that lienholders do not lose their lien rights just because they fail to timely file a claim in the bankruptcy case.<sup>198</sup> The following is a brief description of certain critical issues affecting secured creditors.

#### 1. Bifurcation of Claims Under Section 506 of Code

Section 506 of the Bankruptcy Code provides that a claim which is secured by property of the estate is only secured to the extent of the value of the secured

<sup>194</sup> See, e.g., Local Rule 3003 (Bankr. S.D. Tex.).

<sup>195</sup> *Greyhound Lines, Inc. v. Rogers (In re Eagle Bus. Mfg., Inc.)*, 62 F.3d 730, 735 (5th Cir. 1995); *Chemetron Corp. v. Jones*, 72 F.3d 341, 346 (3d Cir. 1995); *Solow Bldg. Co., L.L.C. v. ATC Assocs.*, 175 F. Supp.2d 465, 471 (E.D.N.Y. 2001).

<sup>196</sup> As explained in *Pioneer Investment Services Co. v. Brunswick Associates*, 507 U.S. 380, 393-95 (1993) (also enunciating the following 4 factors for consideration of whether excusable neglect exists: (i) danger of prejudice to the debtor; (ii) length of delay and its potential impact on judicial proceedings; (iii) the reason for delay, including whether it was in the reasonable control of the movant; and (iv) whether the movant acted in good faith).

<sup>197</sup> See *Butner v. United States*, 440 U.S. 48, 55 (1971). But see *In re Fairview-Takoma Ltd. Pshp.*, 206 B.R. 792, 800-01 (Bankr. D. Md. 1997)

<sup>198</sup> See, e.g., *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992); *FDIC v. Union Entities (In re Be-Mac Transp. Co.)*, 83 F.3d 1020, 1025 (8th Cir. 1996). *Hoxworth v. Blinder*, 74 F.3d 205, 210 (10th Cir. 1996).

<sup>187</sup> See, e.g., 11 U.S.C. § 101(5) (defining "claim," which definition includes unliquidated, contingent and disputed claims).

<sup>188</sup> See, e.g., Fed. R. Bankr. P. 3003(b)(1); see also 11 U.S.C. § 1111(a).

<sup>189</sup> See 4 *Collier's* ¶ 501.01[3].

<sup>190</sup> See, e.g., Fed. R. Bankr. P. 1009 (provisions on amendments to the schedules).

<sup>191</sup> See 11 U.S.C. § 341(a); Fed. R. Bankr. P. 2003(a).

<sup>192</sup> See Fed. R. Bankr. P. 3002(c).

<sup>193</sup> See Fed. R. Bankr. P. 3003(c)(3).

creditor's interest in the collateral.<sup>199</sup> If, for example, a creditor holds a \$10,000 claim secured by property having a value of \$5,000, then under section 506 the creditor will only be entitled to a secured claim in the amount of \$5,000, with the balance treated as an unsecured (deficiency) claim.<sup>200</sup> Similarly, if the creditor holds a second priority lien on the property, and the first priority lienholder has a \$5,000 claim, then the creditor's entire claim will be treated as an unsecured, deficiency claim notwithstanding its lien, because there is no equity in the property left over to secure the creditor's claim after taking into account the first lienholder.

Additionally, to the extent that a creditor's agreement with the debtor provides for the payment of interest and fees, costs and other charges (including, for example, attorney's fees), section 506(b) of the Bankruptcy Code provides that the creditor's secured claim may include these amounts so long as they are reasonable, but only up to the amount of any remaining equity cushion after taking into account the principal amount of the creditor's indebtedness (i.e., the creditor is over-secured).<sup>201</sup>

In effect, section 506 provides a means by which the bankruptcy court may judicially conduct a hypothetical foreclosure for purposes determining how much the secured creditor would get through the foreclosure, and how much would be left over in the form of a deficiency claim. Moreover, the Bankruptcy Code transforms all non-recourse obligations (with certain reasonable exceptions) into recourse obligations for purposes of section 506.<sup>202</sup> Thus, even secured creditors holding non-recourse obligations are ordinarily entitled to unsecured, deficiency claims under section 506.

## 2. Section 1111(b) Election

Bifurcation of a secured creditor's claim is not always attractive to a secured creditor, especially where the creditor strongly disagrees with the bankruptcy court's valuation and distributions to unsecured creditors may not be meaningful. To address this issue, Congress provided yet another option to secured creditors in the context of Chapter 11 cases.

Under section 1111(b) of the Bankruptcy Code, a class of secured creditors may elect to forego their § 506 unsecured, deficiency claims in exchange for allowance, in full, of their claims as secured claims for purposes of a Chapter 11 plan.<sup>203</sup> To make such election, the class members must meet the same voting requirements as is required for acceptance of the plan (see discussion below). Making the § 1111(b) election does not mean, however, that a secured creditor will necessarily get more under the Chapter 11 plan than if the election were not made. The election analysis is complex, and a secured creditor class may be taking a significant gamble in making the election. Details regarding the impact of the election are set out below in the context of plans and plan confirmation requirements.

### D. Claims Objections

If the debtor/trustee or certain other parties in interest believe that a claim is filed incorrectly as to either amount or priority, or that there are certain defenses and/or counterclaims against the claim, then they may object to the claim to reach its merits. The only clear exception to bankruptcy court jurisdiction to hear and determine claim objections relates to claims for personal injury and wrongful death, which must be tried before a federal district court.<sup>204</sup>

Of equal significance, because bankruptcy proceedings are proceedings in equity, there is no right to a jury trial in relation to the determination of claims in bankruptcy.<sup>205</sup> Indeed, by filing a proof of claim, and hence subjecting itself to the bankruptcy court's (or district court's) equitable jurisdiction, a creditor is deemed to have waived its 7th Amendment right to a jury trial to the extent that the creditor had such a right outside of bankruptcy.<sup>206</sup> Thus, if a creditor has several different potential targets for recovery and is keen on determination by a jury, then the creditor may be well-advised to forego or delay its claim against the debtor (focusing instead on the other potential targets) to ensure that the jury trial right is preserved.

## VII. CONFIRMATION ISSUES IN CHAPTER 11

### A. The Chapter 11 Plan and Its Purpose

In a successful Chapter 11 case, the overall resolution the case culminates in the filing, approval and consummation of a plan of reorganization which

<sup>199</sup> See 11 U.S.C. § 506(a).

<sup>200</sup> See *id.*

<sup>201</sup> See 11 U.S.C. § 506(b).

<sup>202</sup> See 11 U.S.C. § 1111(b)(1)(A). Note, however, that there are several exceptions to this transformation which are set forth within § 1111(b).

<sup>203</sup> See 11 U.S.C. § 1111(b)(1)(B).

<sup>204</sup> See 28 U.S.C. § 157(b)(5). See also 28 U.S.C. §§ 157(b)(2)(B), 1334(b).

<sup>205</sup> See *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 42-59 (1989).

<sup>206</sup> *Id.* at 59.

sets out the debtor's proposal for the restructuring of its business and debt. Each creditor holding an unchallenged claim in the bankruptcy case will generally be provided the opportunity to vote for or against the plan, unless the plan proposes to satisfy the creditor's claim under the terms and conditions originally agreed to by the debtor and creditor (making the claim "unimpaired" for purposes of plan confirmation), or provides that the creditor will receive nothing (in which case the creditor is deemed to reject the plan). A plan must set out details regarding how the claims in the case will be treated, how the plan will be implemented, and all other critical terms regarding the overall restructuring of the debtor.<sup>207</sup> Once confirmed, the plan effectively constitutes a contract between the debtor and creditors.

## B. The Disclosure Statement and Its Purpose

In connection with the debtor's solicitation of votes on the plan, a debtor is required to provide a disclosure statement to creditors outlining certain critical information necessary for meaningful consideration of the plan's terms and conditions. The disclosure statement is subject to bankruptcy court approval, and will only be approved if it contains "adequate information."<sup>208</sup>

A disclosure statement contains "adequate information" concerning the plan if such information is "of a kind, and in sufficient detail, as far as is reasonably practical in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or [equity] interests of the relevant class [of creditors or equity holders] to make an informed judgment about the plan..."<sup>209</sup> In other words, the disclosure statement is similar to a prospectus in connection with public offerings of stock or debt, but does not necessarily have to be as detailed as a prospectus depending upon the circumstances involved in the case (including cost limitations).<sup>210</sup>

Such information normally includes an explanation of what led to the bankruptcy filing, a

description and valuation of the debtor's assets, a summary of the debtor's liabilities (broken out by priority within the case), events that have taken place during the bankruptcy case to date, the debtor's business plan going forward, the debtor's proposed treatment of claims, and relevant financial information (e.g., projections and asset liquidation values).<sup>211</sup> Bankruptcy courts have a considerable amount of discretion in determining whether adequate information has been supplied.<sup>212</sup>

## C. Use of the Class Structure and Impact

One of the mandatory requirements of a plan is to segregate differing types of claims into classes. In other words, the plan is not permitted to designate separate proposals as to individual creditors; instead, it must set out proposals as to types of claims, with the types being combined into separate classes of claims.<sup>213</sup>

### 1. Requirements of Classification

In designating different classes of claims, a debtor may only place a type of claim in a particular class if such type of claim is "substantially similar" to all other claims falling within such class.<sup>214</sup> The corollary to this rule is that a debtor may not separately classify a claim that is substantially similar to other claims so as to gerrymander an affirmative vote on the plan.<sup>215</sup>

Additionally, a plan must provide for the same treatment of each claim within a class unless the holder

<sup>211</sup> See *In re United States Brass Corp.*, 194 B.R. 420, 424-25 (Bankr. E.D. Tex. 1996); *Metrocraft Pub. Servs., Inc.*, *supra* note 209, at 568.

<sup>212</sup> The legislative history of section 1125 reveals that what constitutes adequate information involves case-by-case analysis of whether disclosure was adequate based on the facts and circumstances of each case. S. Rep. No. 989, 95th Cong., 2d Sess. 121 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5907. See also *Mabey v. Southwestern Elec. Power Co. (In re Cajun Elec. Power Coop., Inc.)*, 150 F.3d 503, 518 (5th Cir. 1998); *Texas Extrusion Corp. v. Lockheed Corp. (In re Texas Extrusion Corp.)*, 844 F.2d 1142, 1157 (5th Cir. 1988).

<sup>213</sup> 11 U.S.C. § 1123(a)(1).

<sup>214</sup> See *In re Chateaugay Corp.*, 177 B.R. 176, 186 (S.D.N.Y. 1995) ("The express language of 11 U.S.C. § 1122(a) explicitly forbids a plan from placing dissimilar claims in the same class...there must be some limit on the debtor's power to classify creditors...The potential for abuse would be significant otherwise.") (citations omitted), *aff'd* 89 F.3d 942 (2d Cir. 1996); *In re Jersey City Medical Ctr.*, 817 F.2d 1055, 1061 (3d Cir. 1987); 11 U.S.C. § 1122(a).

<sup>215</sup> See *In re Greystone*, 948 F.2d 134, 139 (5th Cir. 1991).

<sup>207</sup> See 11 U.S.C. § 1123 (detailing the mandatory and permissive contents of a plan).

<sup>208</sup> See 11 U.S.C. § 1125(b).

<sup>209</sup> 11 U.S.C. § 1125(a)(1). See also *In re Metrocraft Publishing Services, Inc.*, 39 B.R. 567, 568 (Bankr. N.D. Ga. 1984) (discussion of factors underlying the definition of "adequate information"); *In re Unichem Corporation*, 72 B.R. 95, 96-97 (Bankr. N.D. Ill. 1987), *aff'd*, 80 B.R. 448 (N.D. Ill. 1987).

<sup>210</sup> See, e.g., 7 *Collier's* ¶ 1125.02.

of a particular claim to be treated less favorably agrees to the less favorable treatment.<sup>216</sup>

## 2. Percentage Vote Required

A class of claims is deemed to have voted to accept the plan if, as to the creditors holding claims in such class who actually cast a vote, more than one-half (1/2) of them vote to accept the plan and those holding at least two-thirds (2/3) in amount of the allowed claims in the class vote to accept the plan.<sup>217</sup> With respect to each class of impaired claims, confirmation generally requires that each such class vote to accept the plan.<sup>218</sup> However, provided at least one class of impaired claims has voted to accept the plan (determined without including any acceptances by insiders of the debtor), this requirement may be overridden through the “cramdown” process discussed below.<sup>219</sup>

## D. Critical Confirmation Standards

Confirmation (approval) of the plan by the bankruptcy court is subject to several other mandatory requirements specified in section 1129(a) of the Bankruptcy Code.<sup>220</sup> Of most significance to creditors:

### 1. “Best Interest of Creditors” Test

With respect to each impaired class of claims, confirmation requires that each creditor holding a claim within the class either vote to accept the plan or receive or retain under the plan property of a value that is not less than the amount that such creditor would receive or retain on account of the claim if the debtor were liquidated under Chapter 7 of the Bankruptcy Code.<sup>221</sup> In other words, rejecting creditors holding impaired claims must be assured that they will get at least as much as what they would have otherwise gotten if the debtor were simply liquidated.

In relation to impaired secured creditor classes which have elected § 1111(b) treatment, the test is slightly different. As to each secured creditor within the class, if they reject the plan, then the plan must provide that the creditor will receive or retain property under the plan having a value that is not less than the

value of such creditor’s interest in the collateral securing the creditor’s secured claim.<sup>222</sup> In other words, a § 1111(b) creditor must be assured to get at least as much as what it could get if it were entitled to immediate execution against the collateral.

### 2. Feasibility

Unless the plan is a liquidating plan, i.e. a plan for the orderly liquidation of the debtor, confirmation requires proof that approval of the plan is not likely to be followed by the need for further financial reorganization or liquidation.<sup>223</sup>

### 3. Compliance with Other Provisions of the Bankruptcy Code

Generally, confirmation mandates that the plan comply with all other provisions of the Bankruptcy Code.<sup>224</sup> Thus, if the debtor has utilized a classification scheme for grouping various types of claims in violation of the Bankruptcy Code’s classification requirements, the plan cannot be confirmed.<sup>225</sup> Similarly, if the plan proposes differing treatment as to claims classified within a particular class over the objection of the claimants holding claims to be treated less favorably, the plan cannot be confirmed.<sup>226</sup>

## E. The Cramdown Alternative

If all of the mandatory confirmation requirements are met, save and except the requirement that each impaired class of claims and equity interests has voted to accept the plan, the plan may nevertheless be confirmed by the bankruptcy court under the “cramdown” provisions of the Bankruptcy Code.<sup>227</sup>

### 1. Requirements

Cramdown requires, in relation to each particular rejecting class, that the plan (i) does not discriminate

<sup>216</sup> See 11 U.S.C. § 1123(a)(4).

<sup>217</sup> 11 U.S.C. § 1126(c).

<sup>218</sup> See 11 U.S.C. § 1129(a)(8).

<sup>219</sup> See 11 U.S.C. § 1129(a)(10), (b).

<sup>220</sup> See 11 U.S.C. § 1129(a).

<sup>221</sup> See *Bank of America Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’shp.*, 526 U.S. 434, 441 n. 13 (1999); *In re Labrum & Doak, LLP*, 227 B.R. 372, 381 (Bankr. E.D. Pa. 1998); *In re The Leslie Fay Companies, Inc.*, 207 B.R. 764, 787 (Bankr. S.D.N.Y. 1997); 11 U.S.C. § 1129(a)(7)(A).

<sup>222</sup> See 11 U.S.C. § 1129(a)(7)(B).

<sup>223</sup> See 11 U.S.C. § 1129(a)(11). See also *Financial Sec. Assur. v. T-H New Orleans Ltd. P’shp.* (*In re T-H New Orleans Ltd. P’shp.*), 116 F.3d 790, 801 (5th Cir. 1997); *Made in Detroit, Inc. v. Official Comm. of Unsecured creditors of Made in Detroit, Inc.* (*In re Made in Detroit, Inc.*), 414 F.3d 576, 579 (6th Cir. 2005); *In re Lakeside Global III, Ltd.*, 116 B.R. 499, 506 (Bankr. S.D. Tex. 1989).

<sup>224</sup> See *In re W. Asbestos Co.*, 313 B.R. 832, 840 (Bankr. N.D. Cal. 2003); 11 U.S.C. § 1129(a)(1).

<sup>225</sup> See, e.g., *In re DOW Corning Corp.*, 255 B.R. 445, 528 (E.D. Mich. 2000).

<sup>226</sup> See, e.g., *In re Seatco, Inc.*, 259 B.R. 279, 288 (Bankr. N.D. Tex. 2001).

<sup>227</sup> See *203 N. LaSalle*, 526 U.S. at 441; 11 U.S.C. § 1129(b).

unfairly against the class, and (ii) is fair and equitable.<sup>228</sup>

a. Unfair Discrimination Prohibited. Plans often provide for different payments terms between classes, arguably discrimination, based upon the type of claims involved or the amount of debt at issue within a particular class.

Suppose a debtor proposes to satisfy all unsecured claims by making a distribution equal to 30% of the allowed amount of the claims. Suppose further that the debtor has separately classified vendor claims (aggregating \$500,000) from litigation claims (aggregating \$5 million), and that the plan provides for immediate payment of the vendor claims, but payment over 3 years on the litigation claims. Clearly the class of litigation claims is being discriminated against, but discrimination, in and of itself, is not prohibited. The question is whether the discrimination is “unfair.”<sup>229</sup> The debtor may justify the difference in payment terms based upon the overall debt difference, the fact that the debtor’s vendors are critical to the debtor’s future operations and will not continue to provide favorable payment terms to the debtor in the absence of immediate cash out, and/or that the litigation claims will take longer to finally determine.<sup>230</sup> Only where the plan is providing substantially better treatment to a class containing claims of the same nature as those within another class and there is no reasonable justification for the difference will the bankruptcy court find unfair discrimination.<sup>231</sup>

<sup>228</sup> See *id.*

<sup>229</sup> See *In re Armstrong World Indus.*, 348 B.R. 111, 121 (D. Del. 2006); 7 *Collier's* ¶ 1129.04[3][b][i].

<sup>230</sup> See also *Liberty Nat'l Enters. v. Ambanc La Mesa Ltd. Pshp.* (*In re Ambanc La Mesa Ltd. Pshp.*), 115 F.3d 650, 656 (9th Cir. 1997)(explaining that discrimination may be fair under four criteria: (1) it must be supported by a reasonable basis; (2) the debtor could not confirm or consummate the Plan without it; (3) the discrimination is proposed in good faith; and (4) the degree of discrimination is directly related to the basis or rationale for the discrimination.).

<sup>231</sup> See, e.g., *In re Barney & Carey Co.*, 170 B.R. 17, 26-27 (Bankr. D. Mass. 1994) (plan unfairly discriminated by providing 100% recovery to class of insider claims, but only 15% recovery to rejecting class of general unsecured claims, even though insider claims to be paid over a much longer period of time); *In re Aztec Co.*, 107 B.R. 585, 589 (Bankr. M.D. Tenn. 1989) (plan unfairly discriminated by providing 100% recovery to insider class while only providing 3% recovery to rejecting class of secured creditor deficiency claims).

b. Fair and Equitable Requirement. The second cramdown requirement is that the plan is fair and equitable in relation to the rejecting class. This is, obviously, a very subjective test, and must be determined on a case by case basis based upon the totality of the circumstances at issue. Nevertheless, the Bankruptcy Code sets out certain minimal standards which must be met under this test in relation to the different types of claims bound up in the rejecting class.

## 2. Fair and Equitable Treatment of Secured Claims

In relation to a rejecting class of secured claims, the plan must, at a minimum, provide for one of the following in order to satisfy the fair and equitable test:

Option 1: Lien Retention and Payment in Full of Allowed Secured Claims. Under this option, the plan must propose as to each secured claim within the rejecting class that (i) the claimholder will retain its lien/security interest in the underlying collateral, and (ii) the claimholder will receive on account of the claim deferred cash payments totaling at least the allowed amount of the claim and having a value of at least the value of such claimholder’s interest in the collateral.<sup>232</sup> In other words, each secured creditor within the class must retain its lien/security interest, and receive payments totaling (I) the full face amount of the creditor’s allowed secured claim and (ii) the present value of the creditor’s interest in the collateral. The payment obligation is what makes this test complicated, and this is where the section 1111(b) election becomes very meaningful.

Because payments must equal at least the face amount of the allowed claim, the election can control the precise application of this standard. In the case of a class of secured creditors which may elect section 1111(b) treatment, where a particular creditor thereunder has a \$10 million claim secured by collateral worth \$5 million, the election controls whether payments under the plan over time must aggregate at least \$10 million, or only \$5 million.

Moreover, the requirements are further complicated by the need to calculate the present value of payments that may be deferred over time under a plan. If payments are made over time to the creditor, then the present value of all payments must equal the allowed amount of its secured claim. Consequently, the debtor will need to provide for some level of interest to accrue on the claim during the payment period so that the discounted value of all payments

<sup>232</sup> See *In re D&G Invs. of W. Fla., Inc.*, 342 B.R. 882, 887 (Bankr. M.D. Fla. 2006); 11 U.S.C. § 1129(b)(2)(A)(i).

(including interest) meets the threshold. Needless to say, the selection of an appropriate interest rate is often a source of dispute.<sup>233</sup> In the context of a section 1111(b) election, the analysis becomes even more complicated. Take our example of the creditor with the \$10 million claim and \$5 million collateral, in a class making the election. The requirements of section 1129(b)(2) provide that the total amount of the payments must equal the allowed amount of the claim (\$10 million), but as to the present value requirement, payments need only equal the value of the creditor's interest in the collateral (\$5 million). Therefore, even though our hypothetical plan must provide for payment of \$10 million (the face of the claim) over time to the creditor, confirmation only requires that the payments have a present value equal to \$5 million. Therefore, in this scenario, depending upon the length and terms of the payout, it could be that no or very little interest on the claim is necessary. At least one court has opined that negative amortization on the restructured indebtedness may be permissible under this scenario.<sup>234</sup>

Option 2: Sale of Collateral. Alternatively, the plan may propose a sale of the secured creditor's collateral with the secured creditor's lien/security interest to re-attach to the proceeds of the sale.<sup>235</sup> Ultimately, the idea here is that either the secured claim will be satisfied out the proceeds of its collateral in the form of cash, or if the sale is for something other than cash, then in the form of replacement collateral.

Option 3: Realization of "Indubitable Equivalent". As a final alternative, the plan must propose to satisfy the secured claim generally through realization by the creditor of the "indubitable equivalent" of the creditor's secured claim.<sup>236</sup> The phrase "indubitable equivalent" is nowhere defined in the Bankruptcy Code.<sup>237</sup> Congress extracted the phrase from a 1935 pre-Bankruptcy Code opinion issued out of the Second

Circuit Court of Appeals.<sup>238</sup> Generally, the standard requires that the secured creditor who is to receive something other than what was originally agreed to by the debtor will ultimately receive the value of the agreed upon consideration, vis-à-vis the creditor's allowed secured claim, "without any doubt."<sup>239</sup> The clearest example of this test being satisfied is where the debtor proposes to transfer the underlying collateral to the secured creditor in satisfaction of the secured claim.<sup>240</sup> The test may also be met by providing for payment in accordance with Option 1 above, but as to the lien retention requirement, offering to substitute collateral in its place, so long as the substitute collateral will carry a value in excess of the allowed secured claim during the entire period of repayment.<sup>241</sup>

### 3. Fair and Equitable Treatment of Unsecured Claims

In relation to a rejecting class of unsecured claims, the fair and equitable test requires that the plan, at a minimum, provide for one of the following:

Option 1: Full Satisfaction of Allowed Unsecured Claims. The plan proposes to provide each unsecured creditor with a claim within the rejecting class property of a value equal to the allowed amount of the creditor's unsecured claim.<sup>242</sup> Stated differently, each rejecting creditor within the class must receive (i) an immediate cash payment equal to the amount of its allowed unsecured claim; (ii) deferred cash payments having a present value equal to the amount of the allowed unsecured claim; or (iii) some other property (e.g., equity in the reorganized debtor) having a value at least equal to the allowed unsecured claim.<sup>243</sup>

<sup>238</sup> See *Id.* (citing *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935)).

<sup>239</sup> See *Sandy Ridge Dev. Corp. v. Louisiana Nat'l Bank (In re Sandy Ridge Dev. Corp.)*, 881 F.2d 1346, 1350 (5th Cir. 1989); *In re Freymiller Trucking, Inc.*, 190 B.R. 913, 915-16 (Bankr. W.D. Okla. 1996).

<sup>240</sup> See, e.g., *Sandy Ridge*, *supra* note 239, at 1350; *In re Pennave Properties Assocs.*, 165 B.R. 793 (E.D. Pa. 1994).

<sup>241</sup> See, e.g., *Brite v. Sun Country Dev., Inc. (In re Sun Country Dev., Inc.)*, 764 F.2d 406, 408 (5th Cir. 1985); *Metropolitan Life Ins. Co. v. San Felipe @ Voss, Ltd. (In re San Felipe @ Voss, Ltd.)*, 115 B.R. 526, 531 (S.D. Tex. 1990). But see *Arnold & Baker Farms v. United States ex rel. Farmers Home Admin. (In re Arnold & Baker Farms)*, 85 F.3d 1415, 1421 (9th Cir. 1996) (plan proposing to transfer less than all collateral not the "indubitable equivalent").

<sup>242</sup> See *LaSalle*, 526 U.S. at 441; 11 U.S.C. § 1129(b)(2)(B)(i).

<sup>243</sup> See, e.g., *Ambanc La Mesa Ltd. Pshp.*, 115 F.3d at 654.

<sup>233</sup> See, e.g., *Wade v. Bradford*, 39 F.3d 1126, 1130 (10<sup>th</sup> Cir. 1994); *United Carolina Bank v. Hall*, 993 F.2d 1126, 1131 (4<sup>th</sup> Cir. 1993); *In re Gramercy Twins Assocs.*, 187 B.R. 112, 123-24 (Bankr. S.D.N.Y. 1995); *In re Jordan*, 130 B.R. 185, 192 (Bankr. D.N.J. 1991); *In re Cassell*, 119 B.R. 89 (W.D. Va. 1990).

<sup>234</sup> See *Great Western Bank v. Sierra Woods Group*, 953 F.2d 1174, 1175 (9th Cir. 1992).

<sup>235</sup> See *Regions Bank v. Rivet*, 224 F.3d 483, 491 (5th Cir. 2000); 11 U.S.C. § 1129(b)(2)(A)(ii).

<sup>236</sup> See *Sunflower Racing v. Mid-Continent Racing & Gaming Co. (In re Sunflower Racing)*, 226 B.R. 673, 686 (D. Kan. 1998); 11 U.S.C. § 1129(b)(2)(A)(iii).

<sup>237</sup> *Wiersma v. O.H. Kruse Grain & Milling (In re Wiersma)*, 324 B.R. 92, 111 (9th Cir. B.A.P. 2005).

Option 2: Satisfaction of the Absolute Priority Rule. Alternatively, if such payment in full is not provided, then no creditor or equity holder holding a claim or equity interest that is junior to the claims within the rejecting class of unsecured claims may receive or retain under the plan any property on account of such junior claim or equity interest.<sup>244</sup> This option, commonly referred to as the “absolute priority rule,” is normally the option utilized by debtors. In a nutshell, the absolute priority rule provides that if a rejecting unsecured creditor class receives less than full satisfaction of their claims no claim or equity interest of junior priority may receive anything on account of the plan.<sup>245</sup>

*The “New Value” Exception.* Some cases have outlined a “new value exception” to the absolute priority rule, under which a junior creditor or equity interest holder equity holders agree to contribute something of tangible value to the bankruptcy case in exchange for the right to receive or retain some value from the estate or reorganized debtor under the plan on account of their interests, where such creditor or equity interest holder agrees to contribute some new value in exchange.<sup>246</sup> While a majority of the courts have adopted the new value exception, the exception is not universally accepted.<sup>247</sup> In 1999, when confronted with the question, the Supreme Court avoided ruling directly on the issue by determining that even if the new value exception is valid, the debtor’s plan failed to comply with it because other parties were not given the opportunity to outbid the equity holders for acquisition of the equity interests involved.<sup>248</sup> While not determinative on the question, the Supreme Court’s opinion, at a minimum, suggests that this avenue is

available under plans. In this regard, something of tangible value must be offered by the holders of existing equity; “sweat equity” and other forms of intangible value will not suffice.<sup>249</sup>

## VIII. AVOIDANCE ACTIONS

### A. Overview and Purpose of Avoidance Actions

Because one of the paramount objectives of the bankruptcy process is to provide equality of distribution among claims of equal priority, the Bankruptcy Code incorporates certain provisions intended to recover the value of transfers deemed to be improper with respect to such policy. Transfers made by a debtor shortly before a bankruptcy filing can have the impact of effectively altering such equality in distribution. Similarly, certain unperfected interests in property are not enforceable against categories of unsecured creditors outside of bankruptcy. Therefore, the Bankruptcy Code also contains certain causes of action will enable such unperfected interests to be avoided for the benefit of all unsecured creditors in the case.

### B. Preference Actions

Pursuant to sections 547 and 550 of the Bankruptcy Code, a debtor/trustee may recover certain transfers which a debtor makes within 90 days (in the case of non-insiders of the debtor), or 1 year (in the case of insiders of the debtor) of the bankruptcy filing.<sup>250</sup> These transfers are commonly referred to as “preferences” or “preferential transfers.” The underlying rationale and purpose of such recoveries are that, where a creditor is paid just prior to bankruptcy and others are not (but instead, must look to bankruptcy distributions), the paid creditor has unfairly been “preferred” over others.<sup>251</sup> Accordingly, the Bankruptcy Code includes provisions to recover these transfers for orderly distribution under its priority scheme. There are of course, reasons why a debtor might choose to prefer certain creditors over others, and these incentives underlie section 547’s provision allowing the courts to look farther in time to inspect these transfers where they involve insiders of the debtor.

<sup>244</sup> See *In re Armstrong World Indus.*, 432 F.3d 507, 513 (3d Cir. 2005); 11 U.S.C. § 1129(b)(2)(B)(ii).

<sup>245</sup> See, e.g., *In re Sunflower Racing, Inc.*, 219 B.R. 587, 605 (Bankr. D. Kan. 1998), *aff’d*, 226 B.R. 673 (D. Kan. 1998).

<sup>246</sup> See *Southern Pac. Transp. Co. v. Voluntary Purchasing Groups*, 252 B.R. 373, 389 (E.D. Tex. 2000)(explaining that such new value must be (1) new, (2) in the form of money or money’s worth, (3) reasonably equivalent to the value of the interest retained / received, and (4) necessary to a successful reorganization.).

<sup>247</sup> See *Beal Bank, S.S.B. v. The Way Apartments, D.T.* (*In re The Way Apartments, D.T.*), 201 B.R. 444, 455 (N.D. Tex. 1996); *In re Union Meeting Partners*, 165 B.R. 553, 569-71 (Bankr. E.D. Pa.), *aff’d* 52 F.3d 317 (3d Cir. 1995); *In re One Times Square Assocs. Ltd. Pshp.*, 159 B.R. 695, 706-09 (Bankr. S.D.N.Y. 1993). *But see Unruh v. Rushville State Bank*, 987 F.2d 1506, 1509-10 (10<sup>th</sup> Cir. 1993); *Piedmont Assocs. v. CIGNA Property & Cas. Ins. Co.*, 132 B.R. 75, 79 (N.D. Ga. 1991).

<sup>248</sup> *LaSalle*, 526 U.S. at 443.

<sup>249</sup> *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 122 (1939) (pre-Bankruptcy Code opinion which emphasized the requirement that new value be in the form of “money or money’s worth”).

<sup>250</sup> 11 U.S.C. §§ 547, 550.

<sup>251</sup> See Charles J. Tabb, *Panglossian Preference Paradigm?*, 5 Am. Bankr. Inst. L. Rev. 407, 408-09 (Winter 1997).

### 1. Requirements

Of significance, not all transfers made shortly before bankruptcy are recoverable as preferences; only certain types of transfers under certain circumstances are recoverable. Specifically, pursuant to section 547 of the Bankruptcy Code, the following elements must be established to avoid a transfer as a preference:

- a. The transfer was of a property interest of the debtor;
- b. The transfer was to or for the benefit of a creditor of the debtor at the time;
- c. The transfer was for or on account of an antecedent debt owed by the debtor before the transfer was made;
- d. The transfer was made while the debtor was insolvent;
- e. The transfer was made within the preference period (i.e. within 90 days of the filing for non-insiders, or within 1 year of the filing for insiders); and
- f. The transfer has enabled the creditor to receive more than what the creditor would receive if (i) the case were a Chapter 7 liquidation, (ii) the transfer had not been made, and (iii) the creditor, instead, received payment on the underlying debt in accordance with relevant priority provisions of the Bankruptcy Code.<sup>252</sup>

The Debtor has the burden to establish all of the foregoing elements.<sup>253</sup> Moreover, for purposes of section 547, there is a rebuttable presumption that the debtor was insolvent during the general 90-day preference “window.”<sup>254</sup> Additionally, it is important to understand that a “transfer” may be something other than the payment of monies.<sup>255</sup> It can include, for example, even the creation or perfection of a security interest in property.<sup>256</sup> To the extent that a preferential

<sup>252</sup> 11 U.S.C. § 547(b).

<sup>253</sup> *In re Nelson Co.*, 117 B.R. 813, 816 (Bankr. E.D. Pa. 1990), *aff'd Nelson Co. v. Amquip Corp.*, 128 B.R. 930 (E.D. Pa. 1991).

<sup>254</sup> See 11 U.S.C. § 547(f).

<sup>255</sup> “Transfer” is defined at Bankruptcy Code § 101(54) as including “each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or an interest in property,” and expressly includes the creation of liens, retention of title as security interests and foreclosure of a debtor’s equity of redemption. 11 U.S.C. § 101(54).

<sup>256</sup> See, e.g., *Nelson*, *supra* note 253, at 816 (creation of a judicial lien constitutes transfer which may be preferential); *In re Melon Produce*, 976 F.2d 71, 74 (1st Cir. 1992) (creation or perfection of a security interest may be preferential).

payment is avoided and recovered, the transferee is entitled to the allowance of an unsecured claim in the bankruptcy case.<sup>257</sup>

A closer inspection of the foregoing elements indicates why most trade vendors find the preference scheme to be extremely offensive, even assuming that in many cases (where they find themselves creditors of the debtor and did not receive such transfers), trade vendors of a debtor generally stand to benefit from the recovery of such preferences.<sup>258</sup> The perceived problem is that the elements of the claim do not incorporate any requirement of any collection effort, fault, or other offensive conduct by a creditor at all. Rather, a creditor who has simply conducted business as usual, providing goods and services to a debtor and accepting payment for same (albeit late or early – i.e., out of the ordinary course), can be forced to return the payment received for the goods and services provided.

### 2. Key Defenses

To alleviate some of these concerns, the Bankruptcy Code sets out certain defenses which may insulate the transfer from attack even if it meets all of the elements.

Ordinary Course. A transfer in the ordinary course of business will be immune from attack. To qualify as an ordinary course transfer, the following circumstances must be established by the transferee:

- a. The transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of both the debtor and the transferee;
- b. The transfer was made in the ordinary course of business or financial affairs of the debtor and the transferee; OR
- c. The transfer was made according to ordinary business terms.<sup>259</sup>

Contemporaneous Exchange. Another defense is the contemporaneous exchange defense. In a nutshell,

<sup>257</sup> See 11 U.S.C. § 502(h); Fed. R. Bankr. P. 3002(c)(3), 3003(c)(3).

<sup>258</sup> Tabb, 5 Am. Bankr. Inst. L. Rev. at 418.

<sup>259</sup> See 11 U.S.C. § 547(c)(2). The disjunctive above is intentionally emphasized because it constitutes a revision of pre-BAPCPA law, under which the disjunctive was previously a conjunctive (and). In short, pre-BAPCPA, a creditor was required to prove both that the transfer was ordinary under the debtor’s and creditor’s business practices, or that it was ordinary within the terms of customary industry practice. Now, either will suffice alone.

even if a transfer is technically on account of an antecedent debt, the transfer may nevertheless be immune from attack if the transferee establishes the following:

- d. The transfer was intended by the debtor and the creditor to be a contemporaneous exchange for new value given to the debtor; and
- e. The transfer was, in fact, a substantially contemporaneous exchange.<sup>260</sup>

The obvious rationale here is to prevent litigation over technical preferences which do not fall within the statute's policy. Where both parties to a transaction intend that the debtor will pay contemporaneously for a good or service provided, a creditor should not be punished if the debtor pays a day after the deal is signed or the goods / services are provided (i.e., the obligation technically arose), because in reality, the estate has not been harmed: the creditor has given new value for what it received.<sup>261</sup> "New value" is specifically defined, and includes "money or money's worth in goods, services, or new credit."<sup>262</sup>

Subsequent New Value. Under a similar rationale, Congress has incorporated a further statutory defense further recognizing the unfairness of allowing a bankruptcy estate to obtain benefit of a preference while simultaneously retaining the value of transfers subsequently provided by the defendant creditor. Known as the "subsequent new value defense," it requires that the transferee demonstrate that:

- f. After the transfer was made, the creditor gave new value to or for the benefit of the debtor;
- g. The subsequent transfer was not secured by an otherwise unavoidable security interest (i.e., the creditor is at risk for non-payment of the subsequent transfer); and
- h. The subsequent transfer was not thereafter also followed-up by the debtor with an otherwise unavoidable transfer to or for the benefit of the creditor (i.e. the creditor did not have the subsequent transfer satisfied).<sup>263</sup>

As noted, the same rationale underlying the contemporaneous exchange defense is incorporated here: where a creditor gives (unpaid) value back to the

<sup>260</sup> See 11 U.S.C. § 547(c)(1).

<sup>261</sup> *Jones Truck Lines v. Central States, Southeast & Southwest Areas Pension Fund (In re Jones Truck Lines)*, 130 F.3d 323, 326 (8th Cir. 1997).

<sup>262</sup> 11 U.S.C. § 547(a)(2).

<sup>263</sup> 11 U.S.C. § 547(c)(4).

estate after receiving a preferential transfer, the estate has not been harmed because the transfer was effective "replaced."<sup>264</sup>

It should also be noted that courts have utilized different rules of calculating the impact of this defense, the effects of which can be very significant. Under what is known as the *Garland* Rule, subsequent advances of new value may be used to offset prior (even if not immediately prior) preferences. This rule benefits the creditor because it is able to "carry forward preferences" until they are exhausted by subsequent advances of new value.<sup>265</sup> In contrast, courts using the *Leathers* Rule, or "transactional approach," hold that new value given by a creditor may be used to offset only the immediately preceding preference.<sup>266</sup> "Excess" new value which may remain after application against an immediately preceding, potentially preferential transfer, is lost. Therefore, once each provision of new value has been applied to the immediately preceding preferential transfer, this rule has the effect of carrying forward the remaining balance of each preferential transfer and insulating it against all subsequent provisions of new value. The Fifth Circuit follows the *Garland* (majority) approach.<sup>267</sup>

Purchase Money Security Interests. An additional statutory defense to preference claims relates to the provision of "enabling loans" to a debtor (purchase money security interests). Under applicable state law, perfection of a purchase money security interest may relate back to the time of attachment of the security interest if perfection is accomplished within a short time after attachment. Again, it seems patently unfair to strip a creditor of its perfected purchase money lien interest when the parties intended the creditor to have such interest at the time that the collateral was purchased, perfection occurs shortly thereafter, and such collateral was not purchased with the debtor's funds (again, there has been no diminution of the estate). Accordingly, a creditor who obtains a purchase money security interest may avoid a preference attack by establishing the following:

<sup>264</sup> *Laker v. Vallette (In re Toyota of Jefferson)*, 14 F.3d 1088, 1091 (5th Cir. 1994)

<sup>265</sup> *In re Thomas W. Garland, Inc.*, 19 B.R. 920, 926 (Bankr. E.D. Mo. 1982); *Mosier v. Ever-Fresh Food Co. (In re IRFM, Inc.)*, 52 F.3d 228, 232 (9th Cir. 1995).

<sup>266</sup> *Leathers v. Prime Leather Finishes Co.*, 40 B.R. 248 (D. Maine 1984); *Krohn v. ADM Milling Co. (In re Dependable Food Prods.)*, 193 B.R. 662, 666 (Bankr. E.D.N.Y. 1996).

<sup>267</sup> *Williams v. Agama Sys. (In re Micro Innovations Corp.)*, 185 F.3d 329, 337 (5th Cir. 1999).

- i. The transfer created a security interest in property acquired by the debtor;
  - j. The security interest secures new value that was given at or after the signing of a security agreement that contains a description of such property as collateral;
  - k. The security interest secures new value that was given by or on behalf of the secured party under such agreement;
  - l. The security interest secures new value that was given to enable the debtor to acquire such property;
  - m. The security interest secures new value that was, in fact, used by the debtor to acquire such property; and
  - n. The security interest was perfected by the secured party on or before 30 days after the debtor received possession of such property.<sup>268</sup>
- c. A hypothetical bona fide purchaser (BFP) of real property from the debtor (other than fixtures), against whom applicable law permits such transfer to be perfected, and which hypothetical purchaser obtains the status of a BFP and has perfected such transfer as of the time of the bankruptcy filing.<sup>270</sup>

In other words, this section confers upon the bankruptcy estate the avoidance rights of individual creditors under applicable (often state) law, including but not limited to uniform fraudulent conveyance claims.<sup>271</sup> A debtor/trustee may avoid any transfer in property, including liens and security interests and the perfection of liens and security interests, that a judicial lien creditor, an execution creditor, or a BFP could avoid under applicable non-bankruptcy law.<sup>272</sup> As with a preference, if the creditor is forced to disgorge the transfer, it receives a corresponding unsecured claim in the estate.<sup>273</sup>

### C. “Strong Arm” Actions

The second category of avoidance actions, sometimes referred to as the “strong arm” section, is set out in section 544 of the Bankruptcy Code.<sup>269</sup> Section 544 provides that the debtor/trustee shall have, as of the commencement of the bankruptcy case, and without regard to any actual knowledge of the debtor/trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by:

- a. A hypothetical creditor that extends credit to the debtor at the time of the bankruptcy filing and that obtains at such time, in relation to such credit, a judicial lien on all property on which a creditor on a similar contract could have obtained such a lien;
- b. A hypothetical creditor that extends credit to the debtor at the time of the bankruptcy filing and that obtains at such time, in relation to such credit, an execution against the debtor that is returned unsatisfied at such time; or

### D. Fraudulent Conveyances

Finally, section 548 of the Bankruptcy Code sets out a fraudulent conveyance provision which is very similar to the fraudulent conveyance provisions under state law, with two exceptions. First, under state law, ordinarily only a creditor of the debtor has standing to pursue a fraudulent conveyance action.<sup>274</sup> Under the Bankruptcy Code, much like the approach of section 544, the debtor/trustee is given standing.<sup>275</sup> Second, under state law there is ordinarily a 4-year look-back period for the cause of action.<sup>276</sup> Under the Bankruptcy Code, the look-back period is limited to 2 years from the bankruptcy filing.<sup>277</sup> As under applicable state law, the Bankruptcy Code permits transfers to be avoided in instances of both actual and constructive fraud.<sup>278</sup>

<sup>270</sup> 11 U.S.C. § 544(a).

<sup>271</sup> *Dahar v. Jackson (In re Jackson)*, 459 F.3d 117, 120 (1st Cir. 2006).

<sup>272</sup> *See, e.g., In re Johnson*, 28 B.R. 292, 295 (Bankr. N.D. Ill. 1983).

<sup>273</sup> *See* 11 U.S.C. § 502(h); Fed. R. Bankr. P. 3002(c)(3), 3003(c)(3).

<sup>274</sup> *See, e.g., Tex. Bus. & Com. Code* § 24.001, *et seq.*

<sup>275</sup> *See* 11 U.S.C. § 548(a)(1).

<sup>276</sup> *See, e.g., Tex. Bus. & Com. Code* § 24.010.

<sup>277</sup> 11 U.S.C. § 548(a)(1).

<sup>278</sup> *See Pension Transfer Corp. v. Beneficiaries under the Third Amendment to Fruehauf Trailer Corp. Retirement Plan No. 003 (In re Fruehauf Trailer Corp.)*, 444 F.3d 203, 210 (3d Cir. 2006); 11 U.S.C. § 548(a)(1)(A) (actual fraud), (a)(1)(B) (constructive fraud).

<sup>268</sup> 11 U.S.C. § 547(c)(3). BAPCPA increased this the time period from 20 days. In support of BAPCPA's expansion of preference defenses, it also amended 28 U.S.C. 1409 (governing venue of proceedings related to bankruptcy cases) to provide that avoidance actions for less than \$10,000.00 asserted against noninsiders must be commenced only in the defendant's district of residence. This provision is not limited to preferences.

<sup>269</sup> *See also In re MortgageAmerica Corp.*, 714 F.2d 1266, 1275 (5th Cir. 1983).

In addition, BAPCPA has incorporated an additional ground for the avoidance of insider employment benefits as constructively fraudulent. Under section 548(a)(1)(B)(4), the estate may avoid such an obligation in the absence of reasonably equivalent value, without regard to any insolvency or thin capitalization of the debtor, so long as the transfer is also out of the ordinary course.

## IX. STRATEGIES FOR CONTROLLING A CHAPTER 11 CASE

Maximization of distributions to creditors in a Chapter 11 case is obviously dependent upon effective and efficient administration of the case and timely development of a plan of reorganization by the debtor and debtor's counsel. Occasionally, creditors find themselves embroiled in a bankruptcy case which seems to have no focus and diminishing prospects for any meaningful recovery due to continuing mismanagement, an inability to turn around operational losses, mounting administrative costs, or any combination thereof and certain other relevant factors. In such instances, the debtor's creditors are not without recourse. Several options exist to push the case along or, alternatively, to simply shut the case down through conversion to Chapter 7 or dismissal.

### A. Appointment of Chapter 11 Trustee

One option is to request that an independent trustee be placed in charge of the debtor. Section 1104 of the Bankruptcy Code provides that upon motion made at any time prior to confirmation of a plan, the bankruptcy court may appoint a Chapter 11 trustee if one or both of the following bases are established:

- a. For cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or
- b. If such appointment is in the interests of creditors, any equity security holders, or other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.<sup>279</sup>

In addition, the United States Trustee is required to seek the appointment of a trustee "if there are

<sup>279</sup> See 11 U.S.C. § 1104(a). See also, e.g., *United States v. Schilling (In re Big Rivers Elec. Corp.)*, 355 F.3d 415, 429 (6th Cir. 2004).

reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting."<sup>280</sup>

### B. Examiners

In the absence of outright fraud or other malfeasance by the debtor's management, a bankruptcy court may be extremely reluctant to replace the debtor's management with a Chapter 11 trustee who, no doubt, has no or very little understanding of the debtor's business structure, historical and current operations, and personnel.<sup>281</sup> Among other things, appointment of a Chapter 11 trustee will add an entirely new layer of administrative costs to the case.<sup>282</sup>

One alternative, or at least preliminary step to appointment of a Chapter 11 trustee, is for the court to appoint an examiner having the authority to look into certain allegations raised by the creditors.<sup>283</sup> Indeed, creditors even have the ability to compel appointment of an examiner in certain circumstances in which the bankruptcy court refuses to appoint a Chapter 11 trustee. Specifically, if the request is denied, then upon motion (which may be coupled with the original request for a trustee) made at any time prior to confirmation of a plan, the bankruptcy court "shall" order the appointment of an examiner "to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, irregularity in the management of the affairs of the debtor or by current or former management of the debtor," if one or both of the following is established:

- a. Such appointment is in the interests of creditors, any equity security holders, and other interests of the estate; or
- b. The debtor's fixed, liquidated, unsecured debts, other than debts for goods, services,

<sup>280</sup> 11 U.S.C. § 1104(e).

<sup>281</sup> See, e.g., *Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548, 577 (3d Cir. 2003).

<sup>282</sup> See 11 U.S.C. § 326 (trustee compensation provision), § 327 (provision authorizing employment and compensation of trustee's professionals, including attorneys and accountants).

<sup>283</sup> See 11 U.S.C. § 1104(c).

or taxes, or owing to an insider, exceed \$5 million.<sup>284</sup>

### C. Plan Exclusivity and Competing Plans

Depending upon the creditor's stake in the debtor's reorganization, a third option available to a creditor is to propose its own plan of reorganization for the debtor. Prior to the implementation of BAPCPA, debtors had the exclusive right to file plans of reorganization for the first 120 days of a bankruptcy case, and the exclusive right to solicit acceptances of the plan for the first 180 days of the case. These periods could sometimes be extended on unlimited successive occasions.<sup>285</sup>

Currently, exclusivity periods in larger cases are limited to a maximum of 18 months to file a plan and 20 months to solicit and secure acceptances.<sup>286</sup> In cases involving less than \$2 million in unsecured debt, the exclusivity period for filing a plan has been increased to 180 days, but the maximum time the Court may extend the deadline for filing is limited to 300 days.<sup>287</sup> For such smaller cases, these time periods may be extended, but only if the debtor, after providing notice to parties in interest, demonstrates that it is more likely than not the Court will confirm a plan within a reasonable period of time, a new deadline is imposed at the time the extension is granted, and the order extending time is signed before the existing deadline expires.<sup>288</sup> If the debtor fails to file its plan and disclosure statement, or required acceptances for its plan, within these periods of "exclusivity," then any party with an interest in the case may propose its own plan of reorganization.<sup>289</sup> In such instance, the costs associated with formulating, preparing, filing, soliciting votes on, and obtaining confirmation of the plan, including reasonable attorneys' fees, may be taxed against the debtor if the plan is ultimately confirmed by the bankruptcy court.<sup>290</sup>

While the full import of these recent provisions remains to be seen it is clear that an important source of leverage used by debtors to obtain concessions from their creditor constituencies has been curtailed: no longer may a debtor continuously extend exclusivity to prevent other interested parties from proposing their own plans.

### D. Committee Representation

Another avenue for increasing a party's presence and influence in a Chapter 11 case, which larger unsecured creditors of the debtor should strongly evaluate, is the opportunity to serve on the official committee of unsecured creditors of the debtor ("Committee"). Section 1102(a)(1) of the Code provides for the appointment of a Committee by the United States Trustee.<sup>291</sup> The Committee serves as a vital counterweight to the debtor-in-possession by generally representing the interests of the unsecured creditors of the estate.<sup>292</sup> The Committee performs critical functions such as investigating the assets and liabilities of the estate, negotiating the terms of a plan of reorganization or in some cases proposing its own competing plan.<sup>293</sup>

BAPCPA has bolstered the Committee's functions in two ways. First, the bankruptcy court, upon request of a party in interest and after notice and a hearing, is expressly authorized to order the United States Trustee to change the membership of the Committee, including by expanding its members, if the Court determines that the Committee's makeup does not ensure adequate representation of creditors or equity security holders.<sup>294</sup>

Secondly, section 1102(b)(3) now provides that Committees must share information with similar creditors who are not members of the Committee. This subsection also requires the Committee to solicit and receive comments from similar creditors who are not members, and provides that Committees are subject to a court order that compels any additional report or disclosure to be made to creditors who are not members.<sup>295</sup>

<sup>284</sup> See *id.*; see also, e.g., *In re UAL Corp.*, 307 B.R. 80, 84 (Bankr. N.D. Ill. 2004) ("appointment of an examiner is mandatory if the...conditions are met, but the court retains the discretion to determine the nature and scope of the examiner's investigation."); *In re Bradlees Stores*, 209 B.R. 36, 38 (Bankr. S.D.N.Y. 1997).

<sup>285</sup> See, e.g., *Levin & Ranney-Marinelli*, 79 Am. Bankr. L.J. at 631.

<sup>286</sup> 11 U.S.C. § 1121(d).

<sup>287</sup> 11 U.S.C. § 1121(e).

<sup>288</sup> *Id.*

<sup>289</sup> See 11 U.S.C. § 1121(c).

<sup>290</sup> See 11 U.S.C. § 503(b)(3)(D), (b)(4), (b)(5) (providing for the allowance of a party's reasonable costs as an

administrative claim in the case where the party makes a "substantial contribution" to the case).

<sup>291</sup> 11 U.S.C. § 1102(a)(1).

<sup>292</sup> See *In re Seascapes Cruises, Ltd.*, 131 B.R. 241, 243 (Bankr. S.D. Fla. 1991).

<sup>293</sup> See, e.g., *In re Eastern Me. Elec. Co-op, Inc.*, 121 B.R. 917, 932 (Bankr. D. Me. 1990); J. Bradley Johnston, *The Bankruptcy Bargain*, 65 Am. Bankr. L.J. 213, 270 (Winter 1991).

<sup>294</sup> 11 U.S.C. § 1102(a)(4).

<sup>295</sup> 11 U.S.C. § 1102(b)(3).

### E. Conversion and Dismissal

Finally, a creditor may simply request conversion of the bankruptcy case to a Chapter 7 liquidation or move for dismissal of the bankruptcy case entirely. Such a request is made pursuant to section 1112(b) of the Bankruptcy Code, which has also undergone substantial revision through BAPCPA. Currently, if, on request of a party to convert or dismiss a case and after notice and a hearing, the court finds cause, the court is required (absent unusual circumstances) to convert or dismiss the case, depending on which option is in the best interests of creditors and the estate.<sup>296</sup>

In addition to requiring the court to expressly find unusual circumstances to deny such relief, section 1112(b)(2) also requires the debtor or another party in interest to establish either that: (A) there is a reasonable likelihood that a plan will be confirmed within a reasonable period of time; or (B) the reason for conversion or dismissal is an act or omission for which the debtor had reasonable justification and it can be cured in a reasonable time.<sup>297</sup>

In addition, the court is required to commence a hearing on such a request “not later than 30 days after filing of the motion, and shall decide the motion not later than 15 days after commencement of such hearing, unless the movant expressly consents to a continuance for a specific period of time or compelling circumstances prevent the Court from meeting the time limits established by this paragraph.”<sup>298</sup>

Finally, the scope of “cause” has been expressly expanded considerably, and now encompasses: gross mismanagement of the estate, failure to maintain appropriate insurance that poses a risk to the estate or to the public, unauthorized use of cash collateral substantially harmful to one or more creditors and failure to comply with an order of the Court.<sup>299</sup> The Court may still appoint a trustee or examiner instead of converting or dismissing the case if such an appointment is in the best interests of creditors and the estate.<sup>300</sup>

### X. CONCLUSION

In summary, the foregoing provides an outline of certain critical aspects of the business bankruptcy process, certain key provisions and concepts within the Bankruptcy Code, and certain key strategies for

dealing with business bankruptcy cases. It is important, of course, to understand that this paper is merely a broad overview of the Bankruptcy Code’s relevant provisions and issues arising thereunder, and that interested parties should consult with experienced counsel with respect to same. Nevertheless, it is the author’s hope that reader may nevertheless obtain a general understanding of these issues and concepts sufficient to allow it to approach bankruptcy case strategy and consultation from an informed vantage.

---

<sup>296</sup> 11 U.S.C. § 1112(b).

<sup>297</sup> 11 U.S.C. § 1112(b)(2).

<sup>298</sup> 11 U.S.C. § 1112(b)(3).

<sup>299</sup> 11 U.S.C. § 1112(b)(4).

<sup>300</sup> See *In re Jayo*, 2006 Bankr. LEXIS 1996, \*29-31 (Bankr. D. Idaho 2006)