

What Every Business Lawyer Needs to Know About the Bankruptcy Process

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FUNDAMENTALS OF THE BANKRUPTCY PROCESS

Types of Bankruptcy

Title 11 of the U.S. Code: The Bankruptcy Code

- Chapter 7: Liquidation
- Chapter 9: Municipalities
- Chapter 11: Reorganization
- Chapter 12: Family Farmers/Family Fishermen
- Chapter 13: Individuals Meeting Certain Standards
- Chapter 15: Cross-Border/International Cases

The Players

- Debtor v. Debtor-In-Possession
- U.S. Trustee
- Chapter 7 Trustee
- Official Committees
 - Creditors
 - Equity
 - Others
- Unofficial Committee

Bankruptcy Courts



Bankruptcy Rules

- Each bankruptcy court has its own local rules, available on the court's websites. You must also be familiar with the district court's local rules.
- All of the bankruptcy courts use electronic case filing (ECF), where papers are filed electronically. The ECF Procedures vary from court to court, and are on each court's website.
- One must be an ECF Filer to be able to file a notice of appearance and other papers. To be an ECF Filer requires an advance registration, and having taken ECF training in at least one bankruptcy court. Being a district court ECF Filer does not qualify an attorney to be a bankruptcy court ECF Filer.
- Individuals can file proofs of claim and other papers by traditional paper means, as opposed to electronically.

Filing a Bankruptcy Petition

- Voluntary – 11 U.S.C. § 301
- Starts with a petition filed by the debtor
- Chapter 9, 12, and 13 cases must be voluntary
- Debtor need not be insolvent
- Automatic stay applies
 - Limitations on use and disposition of property
- Involuntary – 11 U.S.C. § 303
- Starts with a petition filed by petitioning creditor(s)
 - Debtor has 20 days to contest bankruptcy
- If contested, creditor must prove debtor is not paying debts as they come due
 - Eligibility requirements
- Automatic stay applies
 - Gap period

Schedules, Statements & First Day Motions

- Summary of business debtor's assets and liabilities
 - Schedule A/B: Assets – Real and Personal Property
 - Schedule D: Creditors Who Hold Claims Secured By Property
 - Schedule E/F: Creditors Who Have Unsecured Claims
 - Schedule G: Executory Contracts and Unexpired Leases
 - Schedule H: Your Codebtors
- Statement of the debtor's financial affairs
- Declaration by the debtor
- SEC attachment for certain Chapter 11 debtors
- First Day Motions to, *inter alia*:
 - Pay Pre-Petition Employee Wages
 - Pay Pre-Petition Claims of Critical Vendors
 - Use Cash Collateral
 - Honor Pre-Petition Obligations to Customers
 - Provide Adequate Assurance to Utilities
 - Retain Professionals

Creditor Matrix

- Sample (courtesy of U.S. Bankruptcy Court, District of Nevada)

INTERNAL REVENUE SERVICE
110 CITY PARKWAY, STOP 5028
LAS VEGAS, NV 89106

RC WILLEY FINANCIAL SERVICES
POB 65320
SALT LAKE CITY, UT 84165

WFS FINANCIAL
POB 25341
SANTA ANA, CA 92799

SPRINT PCS
POB 7850
BALDWIN PARK, CA 91706

WACHOVIA BANK
2300 W. SAHARA AVE. #500
LAS VEGAS, NV 89102

CONSUMER DEBTOR SERVICES
1606 E. TURKEYFOOT LAKE ROAD
AKRON, OH 44312

First Meeting of Creditors



Exemptions



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Discharge and Dischargeable Debts

- Discharge
 - The right to relief from non-exempt debts
 - How obtained?
 - Ch. 7: order from court
 - Ch. 11: plan confirmation
 - Ch. 13: completion of payments under plan
 - Denial of discharge for debtor's bad acts
 - 11 U.S.C. § 727
- Dischargeability
 - The right to relief as to a specific debt
 - Why would a specific debt be nondischargeable?
 - 11 U.S.C. § 523 – grounds for denying discharge, e.g.,
 - Fraud/false representations
 - Domestic support obligations
 - Willful & malicious injury

Property of the Estate (§ 541)

- The bankruptcy estate is a legal entity created upon the commencement of a bankruptcy case
- Estate is a broad concept and includes all legal or equitable interests of the debtor in property as of the commencement of the case
- The extent of rights determined according to applicable non-bankruptcy law

Ethical Considerations

- Debtor's counsel must be a "disinterested person"
- Debtor's counsel must not have adverse interests to estate
- Limitations on committee's counsel – 11 U.S.C. § 1103(b)
- Trustee's special counsel – 11 U.S.C. § 327
- FRBP 2014 - Failure to make full disclosure of "connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee" could result in sanctions, including disgorgement of fees.

IMPACT OF THE BANKRUPTCY PROCESS ON BUSINESS OPERATIONS

The Automatic Stay (§ 362)

- Purpose
- How it Works
 - The automatic stay stays litigation against a debtor that was or could have been commenced prior to the commencement of the case, whether by way of administrative, judicial or similar proceedings or any attempt to collect or recover a prepetition claim against the debtor, the debtor's property or property of the estate.
 - However, the automatic stay does not apply to claims that arise *after* the commencement of the case.
- How it Affects Litigation

Exceptions to the Automatic Stay

- The automatic stay does not apply to:
 - the commencement or continuation of a criminal action or proceeding against a debtor;
 - an action to enforce a governmental unit's police or regulatory powers;
 - the filing of a continuation statement to keep a UCC-1 financing statement effective; and
 - several types of securities and similar financial transactions are also excepted from the stay. 11 U.S.C. §362(b).

Beneficiaries of the Automatic Stay

- The automatic stay generally applies only to the debtor, property of the debtor, and property of the estate.
- The automatic stay generally does not apply to:
 - third parties such as principals, officers, directors or affiliate non-debtors of a debtor.
 - co-defendants in litigation in which the debtor is also a party.
- Section 105(a) injunctions – extension of stay to officers/affiliates

Termination of the Automatic Stay

- The automatic stay automatically terminates when:
 - the case is dismissed or the debtor receives a discharge;
 - property is no longer property of the estate;
 - if the debtor filed a bankruptcy that was dismissed within one (1) year of the filing then the automatic stay terminates 30 days from the filing unless the debtor can show that the second case was filed in good faith, or
 - if the debtor has had two (2) or more bankruptcy cases dismissed within the past year.

Relief from the Automatic Stay

- Relief may be obtained from the automatic stay by filing a motion.
- There are various grounds that exist upon which relief may be granted:
 - (i) "cause"
 - (ii) where the debtor does not have any equity in the property at issue and the property is not necessary for an effective reorganization of the debtor.

Violating the Automatic Stay

If a creditor violates the automatic stay with knowledge of the pending bankruptcy case, the court can and will impose sanctions against the creditor for violating the stay. 11 U.S.C. §362(k).

Doing Business with a Debtor in Bankruptcy

In Chapter 11 cases a debtor may operate its business and use its property in the ordinary course of business, without permission from the bankruptcy court.

“Ordinary course of business” is not defined.

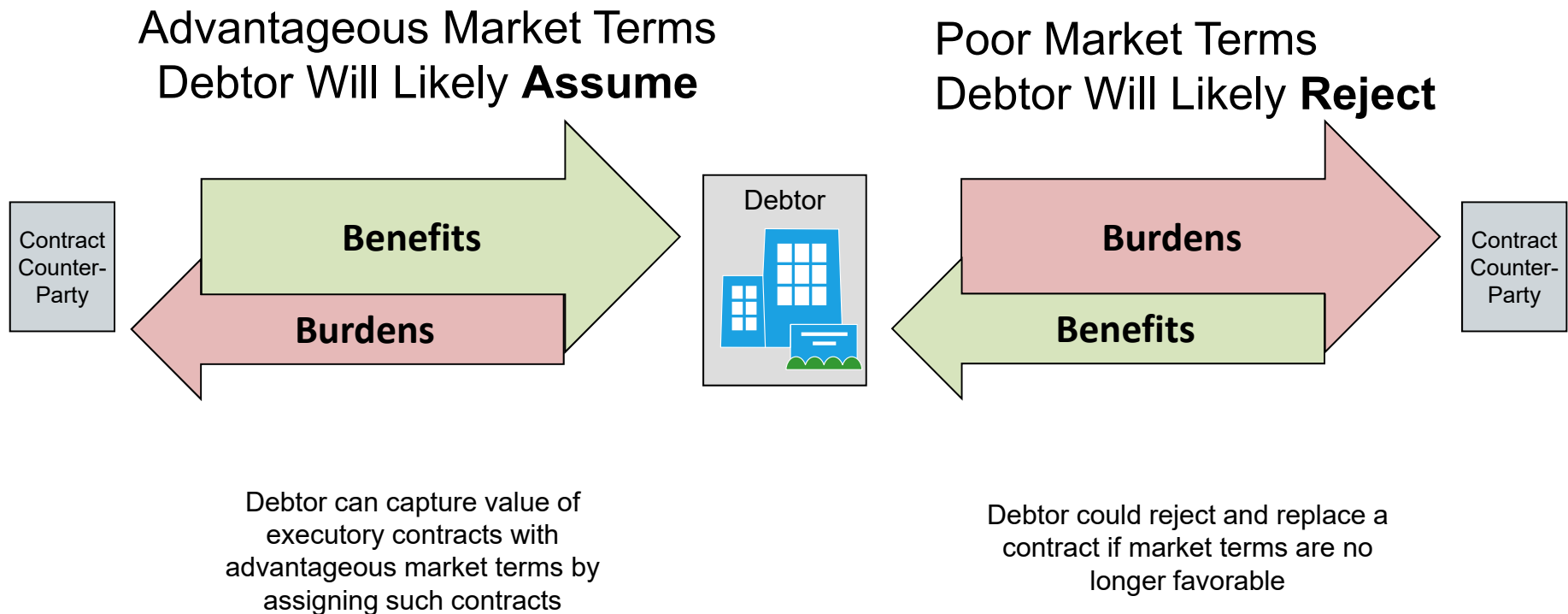
If lien on Debtor’s cash, then Debtor needs lender’s consent or bankruptcy court’s authority to use cash.

Executory Contracts (§ 365)

- Executory contracts are contracts on which **performance remains due by both parties** (i.e., if one party has fully performed its obligations, the contract is no longer executory) (majority rule)
- Debtor decides whether to agree to perform (**assume**) or not perform (**reject**) its obligations under an executory contract
- If the debtor assumes an executory contract, the debtor has to “**cure**” (i.e., pay in full) any amounts due or other defaults and provide the counterparty “**adequate assurance of future performance**” that it can continue to perform in the future

Administering Executory Contracts

Ability to assume and reject executory contracts allows a debtor to maximize value of its estate by **capturing advantageous market terms**



Contract Termination and the Automatic Stay

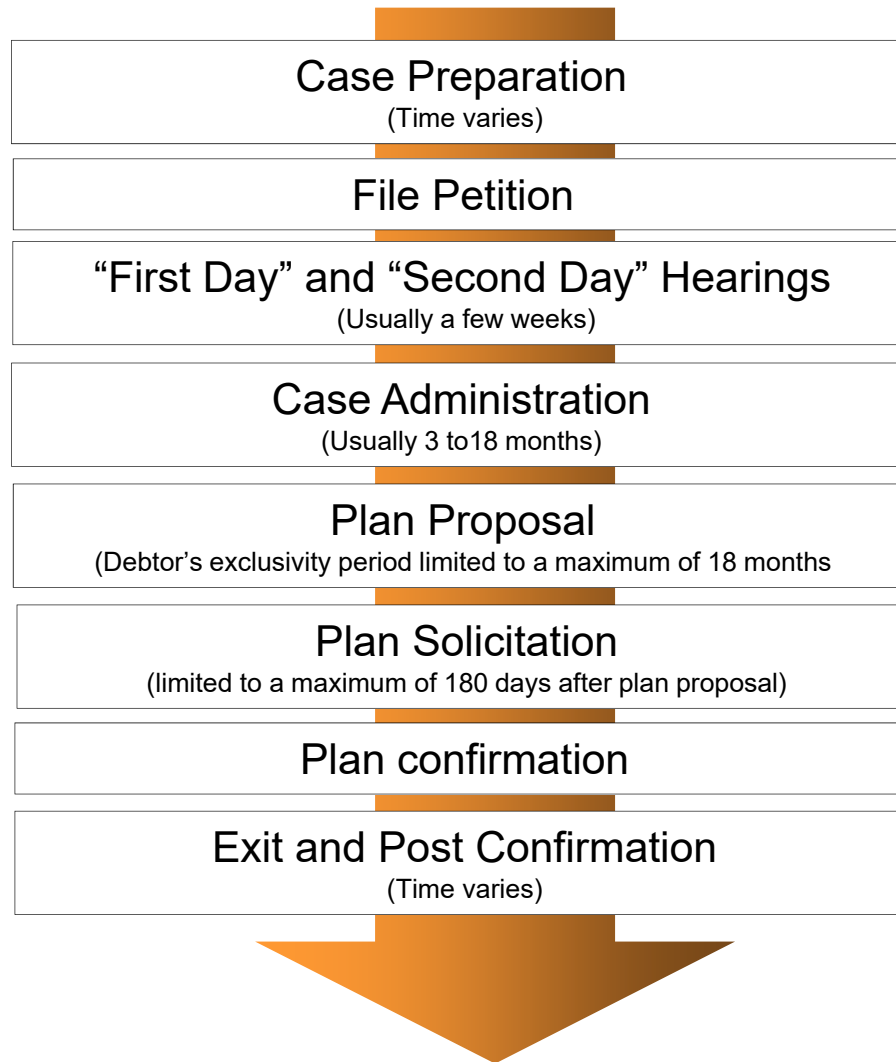
- Generally, ***ipso facto* clauses** (i.e., bankruptcy termination provisions) are unenforceable against Debtor in bankruptcy.
- **Example:** This Agreement shall terminate, without notice, (i) upon the institution by or against either party of insolvency, receivership or bankruptcy proceedings or any other proceedings for the settlement of either party's debts, (ii) upon either party making an assignment for the benefit of creditors, or (iii) upon either party's dissolution or ceasing to do business.
- Affirmatively terminating a contract after the Debtor's bankruptcy filing violates the automatic stay.
- Strategies for protecting termination rights include:
 - Fixed termination dates/affirmative renewals
 - Be proactive

Limitations on Assumption, Assignment & Rejection

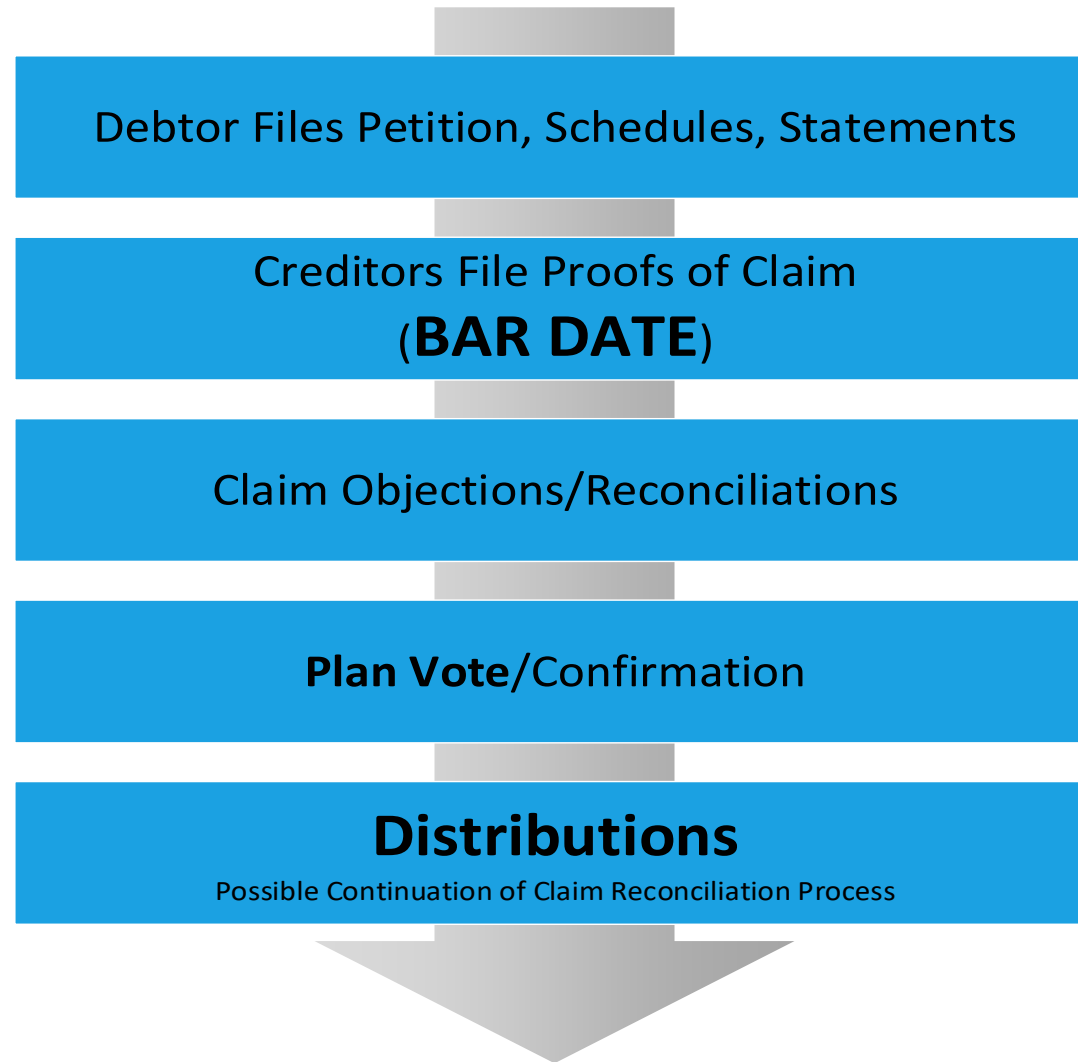
- Debtor must assume entire contract or reject entire contract, Debtor cannot assume parts and reject parts
- **“Personal service” contracts, non-exclusive license agreements, and partnership agreements** may not be assigned without consent.
- Debtor may not assume **financial accommodations contracts** (i.e., agreements to lend Debtor money).
- Debtor cannot reject covenants that survive a breach of the contract such as **covenant not to compete**.

CHAPTER 11 PROCESS

Chapter 11 Process



Chapter 11 Creditor Milestones



Creditor's Committee

(Official Committee of Unsecured Creditors)

- Appointed by the U.S. Trustee
- Cross-section of the debtor's unsecured creditors (generally 7 members, sometimes 3 or 5 members)
- Fiduciary duty to all unsecured creditors to maintain the estate's value
- Consults with the debtor in possession on administration of the case
- Investigates the debtor's conduct and operation of the business
- Participates in formulating a plan

Chapter 11 “First Day” Pleadings

“First Day” Declaration

- Accompanies the First Day Motions and sets forth the business circumstances leading to bankruptcy and pertinent facts
- Usually provided by the debtor's CEO or CFO

Procedural Relief “First Day” Motions Include:

- Joint Administration Motion
- Motion to Extend Time To File Schedules of Assets and Liabilities and Statements of Financial Affairs
- Motions Seeking Approval of Information Sharing Arrangements

Chapter 11 “First Day” Pleadings

Substantive Relief “First Day” Motions Include:

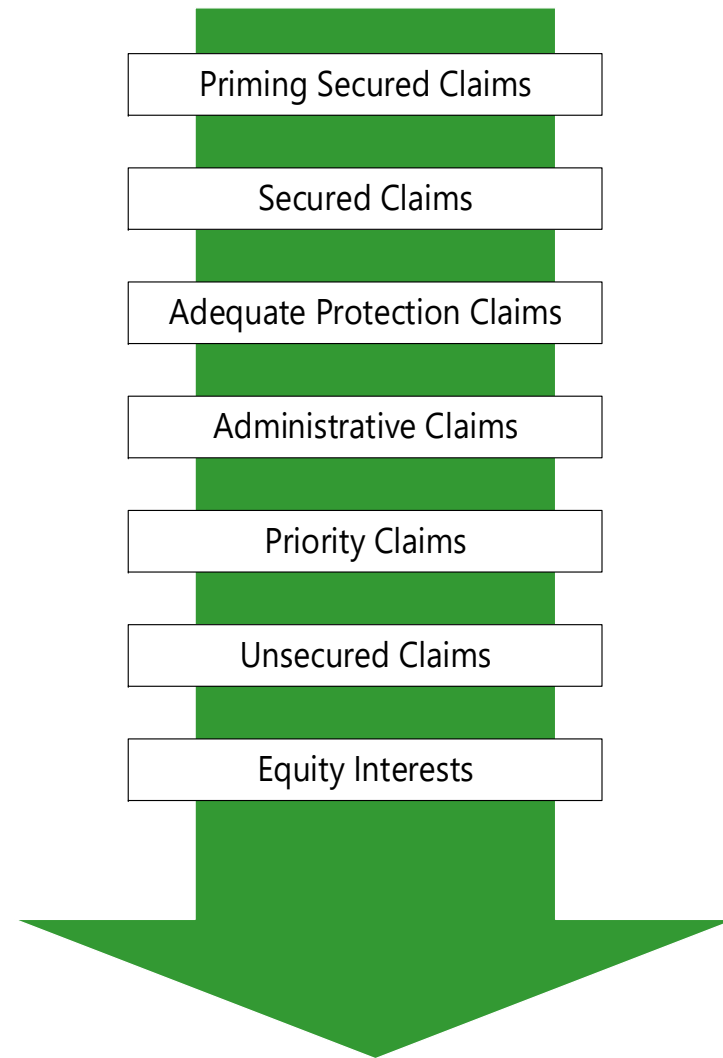
- DIP Financing/Cash Collateral Motion
- Essential Vendors Motion
- Cash Management Motion
- Wages Motion
- Utilities Motion
- Insurance Motion

Chapter 11 Plan

- In a chapter 11 bankruptcy case, the payment of pre-petition claims await the judicial approval (called “confirmation”) and implementation of a Chapter 11 Plan.
- The Chapter 11 Plan may be a reorganization or a liquidation of the Debtor’s assets.
- The Chapter 11 Plan is essentially a court-approved modification of the relationships between the Debtor, its creditors, and other stake holders.
- The Chapter 11 Plan may provide for the classification and treatment of creditors and interest holders.
- Chapter 11 Plans can use a variety of transactions, such as payments from the Debtor’s continuing business operations or proceeds of asset sales, the issuance of shares or rights offerings, or the distribution of litigation proceeds or beneficial interests in trusts.
- Depending on the terms of the Chapter 11 Plan, a creditor may receive any amount between nothing and 100 percent of the amount of its pre-petition claim.

Priority of Claims (Waterfall)

- **Secured Claims** include contractual and statutory rights on the Debtor's assets and setoff claims
- **Adequate Protection Claims** are claims to compensate a secured claim holder for a decrease in the value of its collateral during the bankruptcy case; adequate protection requires the party to seek affirmative relief from the Bankruptcy Court
- **Administrative Expense Claims** include obligations incurred by Debtor during the bankruptcy case (the actual, necessary costs and expenses of preserving the estate)
- **Unsecured Claims** generally comprise the largest number of claims against Debtor and generally receive nothing or a fraction of the claim



Chapter 11 Plans Address Creditor Hold-Outs

- **Class Voting and Approval**
 - To obtain confirmation of the plan, the debtor must obtain the requisite number of creditors, both in **number (more than 50%)** and **amount (at least 2/3's)** of their claims, accept the plan for it to become final, as well as to show that the plan complies with numerous other requirements of the Bankruptcy Code.
 - Does not require unanimity
- **Cramdown**
 - The term “cramdown” refers to provisions in the Bankruptcy Code that allow a bankruptcy court to confirm a plan rejected by one or more impaired classes of creditors.
 - To effectuate cramdown, section 1129(b) mandates that a plan not discriminate unfairly and be “fair and equitable” with respect to impaired, non-accepting classes.

ASSET SALES

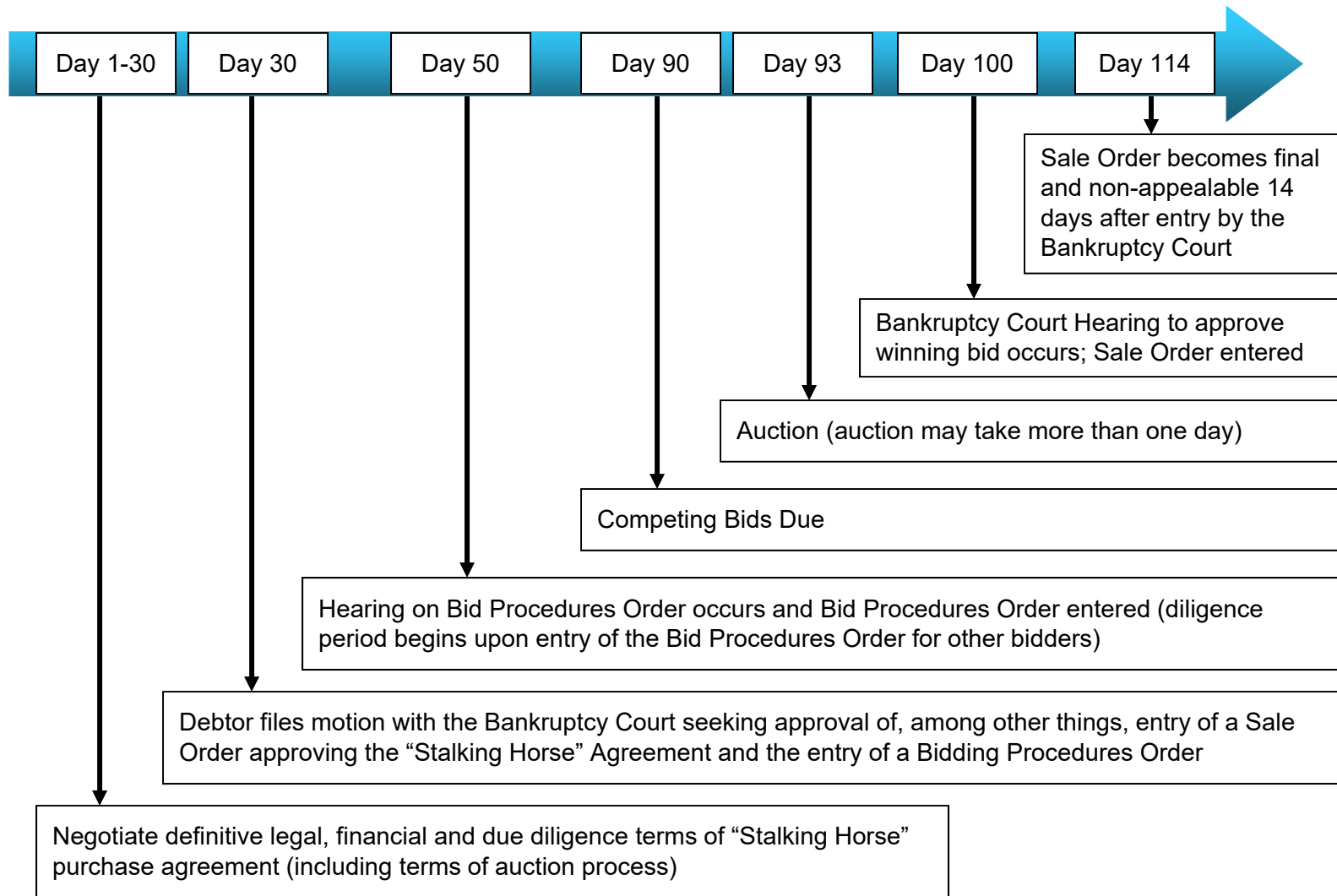
Bankruptcy v. Non-Bankruptcy Sales

- Title to Assets: Sales can be “free and clear” of liens and encumbrances, liens attach to proceeds
- Authority to Enter into Sale: Sales outside ordinary course of business require approval of the Bankruptcy Court
- Exclusivity/No-Shop Provisions: Generally not used and not enforceable in bankruptcy
- Consideration/Purchase Price: Usually cash and assumption of certain liabilities (not usually earn-outs)
- Assigned Contracts: Consent of counter-party not required in bankruptcy
- Representations, Warranties, and Survival of Claims: Usually limited representations and warranties and time to bring claims after closing

Auction Process & “Stalking Horse”

- In bankruptcy, competitive auction process is commonly used to sell assets
- A stalking-horse bid is an initial bid on a bankrupt company’s assets
- Benefits to being a “Stalking Horse” Bidder
 - Can set pricing strategy and the form of the sale agreement
 - Participates in the development of a favorable bid procedures order
 - Longer due diligence period compared to other bidders
- Protections for “Stalking Horse” Bidder
 - Break-up fee (normally in the range of 1%-3% of the aggregate purchase price)
 - Expense reimbursement

Hypothetical 363 Sale Timeline



(Timelines can be and often are shortened)

BASICS OF BANKRUPTCY LITIGATION

Jurisdiction

- Adversary proceeding versus contested matters
- 28 U.S.C. §1334(a) vests the district court with original and exclusive jurisdiction of bankruptcy cases (i.e., the entire case that is commenced by the filing of a petition).
- A “proceeding” is a specific dispute that arises in a case to which a district court has original, but not exclusive, jurisdiction for to those matters that arise or are related to the bankruptcy case (i.e. the adjudication of rights that arise in or by virtue of the Bankruptcy Code).
- The term “proceeding” includes adversary proceedings (i.e., a lawsuit) and contested matters (i.e., motions filed in the bankruptcy case).

Venue

- Under 28 U.S.C. § 1334(a), bankruptcy jurisdiction is vested with the district court, which refers jurisdiction to the bankruptcy court under the authority of 28 U.S.C. § 157(a). Each district court has referred bankruptcy cases to the bankruptcy judges in its district.
- Bankruptcy gives rise to a right of removal in appropriate proceedings, independent of removal based on diversity or federal question (*i.e.*, under 28 U.S.C. §1441).
- Removed cases may be remanded on any equitable grounds. 28 U.S.C. §1452(b).

Core Matters v. Non-Core Matters

- 28 U.S.C. §157 makes a distinction between "core" versus "non-core" matters.
- If a matter is determined by the bankruptcy court to be a "core" proceeding, then the bankruptcy court has jurisdiction to make findings of fact and conclusions of law.
- *Stern v. Marshall*, 131 U.S. 2594 (2011) and *Wellness International Network, Ltd. v. Sharif*, 135 S. Ct. 1932 (2015).

Jury Trial Rights

- Bankruptcy judges can conduct jury trials where there is a right to trial by jury only with the consent of the parties, and if specifically designated by the district court. 28 U.S.C. § 157(e).
- The Federal Rules of Civil Procedure relating to jury trials are incorporated into bankruptcy proceedings. See F.R.B.P 9015.
- It is rare for a bankruptcy judge to conduct a jury trial.

The Bankruptcy Rules

- Procedures applicable to adversary proceedings are contained Part VII of the Bankruptcy Rules, and make much of the Civil Rules applicable; yet with variations. *See e.g.*, F.R.B.P. 7003; F.R.B.P. 7012.
- Other of the Civil Rules are incorporated into the Bankruptcy Rules and thus applicable in the bankruptcy case (as opposed to just in an adversary proceeding). *See e.g.*, F.R.B.P. 9015 (making F.R.C.P. 45 applicable); F.R.B.P. 9024 (making F.R.C.P. 60 applicable with variations).
- Many of the Civil Rules applicable to adversary proceedings are also applicable to contested matters. F.R.B.P. 9014. However, no discovery is permitted in contested matters without leave of the Court.
- The Federal Rules of Evidence apply in the Bankruptcy Court. F.R.B.P. 9017. However, the Federal Rules of Appellate Procedure do not apply to appeals to the District Court or the Bankruptcy Appellate Panel.

Rule 2004 Discovery

- Discovery in a bankruptcy case is governed by Federal Rule of Bankruptcy Procedure 2004, which provides for a motion to the court seeking an order compelling the examination (a "Rule 2004 Exam") of any entity.
- There does not have to be a pending controversy for a Rule 2004 Exam to be ordered. Rule 2004 Exams are commonly used as pre-filing discovery to determine the existence of causes of action.
- The scope of a Rule 2004 Exam is broad and has been likened to a fishing expedition. The exam "must relate only to the acts, conduct or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the estate . . ." Rule 2004(b).

Rule 2004 Discovery

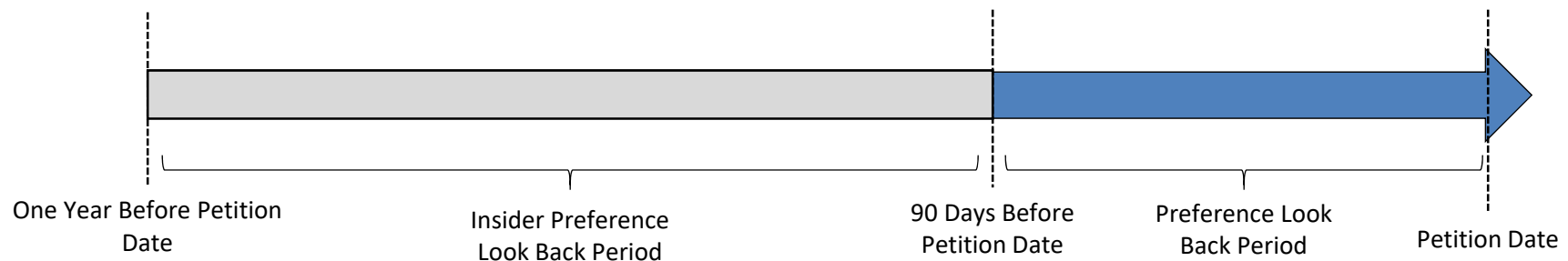
- Once an adversary proceeding or contested matter is commenced, Rule 2004 does not apply, and the Federal Rules of Civil Procedure, to the extent made applicable by the Bankruptcy Rules, apply. *See In re Enron Corp.*, 281 B.R. 836, 840 (Bankr. S.D. N.Y. 2004).
- Rule 2004 is implemented by the issuance of a subpoena under Rule 9016, which makes Rule 45 applicable.

Bankruptcy Litigation Generally

- Avoidance actions are the most common type of bankruptcy litigation.
- “Avoid” in this context means that the bankruptcy estate is returned to the position it would have been in had the transfer not occurred
 - Either the transferred property (or its equivalent cash value) is recovered, or the incurred obligation is avoided
- Two significant types of avoidance actions
 - **Preference** – Recovery of pre-petition transfers on account of antecedent debt
 - **Fraudulent transfer** – Recovery of actual or constructive fraudulent transfers
- Avoidance Claims must be commenced within two years of the filing of the bankruptcy petition.

Preference Actions

- Section 547 of the Bankruptcy Code provides that a Debtor may avoid a:
 - **Transfer** of an **interest** of the Debtor in **property**;
 - **To** or **for the benefit** of a creditor;
 - For or on account of an **antecedent debt** owed by the Debtor before such transfer was made;
 - Made while the Debtor was **insolvent**;
 - Made on or within 90 days before the filing of the petition (or between 90 days and one year if such creditor was an “insider”); and
 - That enables the creditor to receive more that it would have received if the transfer had not been made and the Debtor were liquidated in a case under chapter 7



Insider Status

- The Bankruptcy Code provides a non-exhaustive list of parties that constitute “insiders.”
- In addition to the list, case law has developed a concept of “nonstatutory insiders.” See 11 U.S.C. 101(31), which has allowed Bankruptcy Courts to expand the scope of “insider” beyond the traditional insiders.
- To find insider status, the relationship between the Debtor and creditor must “compel the conclusion” that the parties are “close enough to gain an advantage attributable simply to affinity rather than to the course of dealings between the parties.”

Examples of Statutory Exceptions to Preferences

- Contemporaneous exchange for new value
- Payments in the Ordinary Course
- Purchase Money Security Interests
- Offset by Unsecured Credit
- De Minimis Amount Exceptions

Actual Fraud - § 548(a)(1)(A)

- This section allows the avoidance of transfers two years prior to filing of the bankruptcy petition with actual intent to hinder, delay or defraud.
- Complaint must satisfy Rule 9(b)'s heightened pleading standard. *Gowan v. Patriot Grp., LLC (In re Dreier LLP)*, 452 B.R. 391, 422 (Bankr. S.D.N.Y. 2011).
- Burden of Proof:
 - Majority view : burden is a preponderance of the evidence
 - Minority view: some courts require clear and convincing evidence
- Badges of Fraud

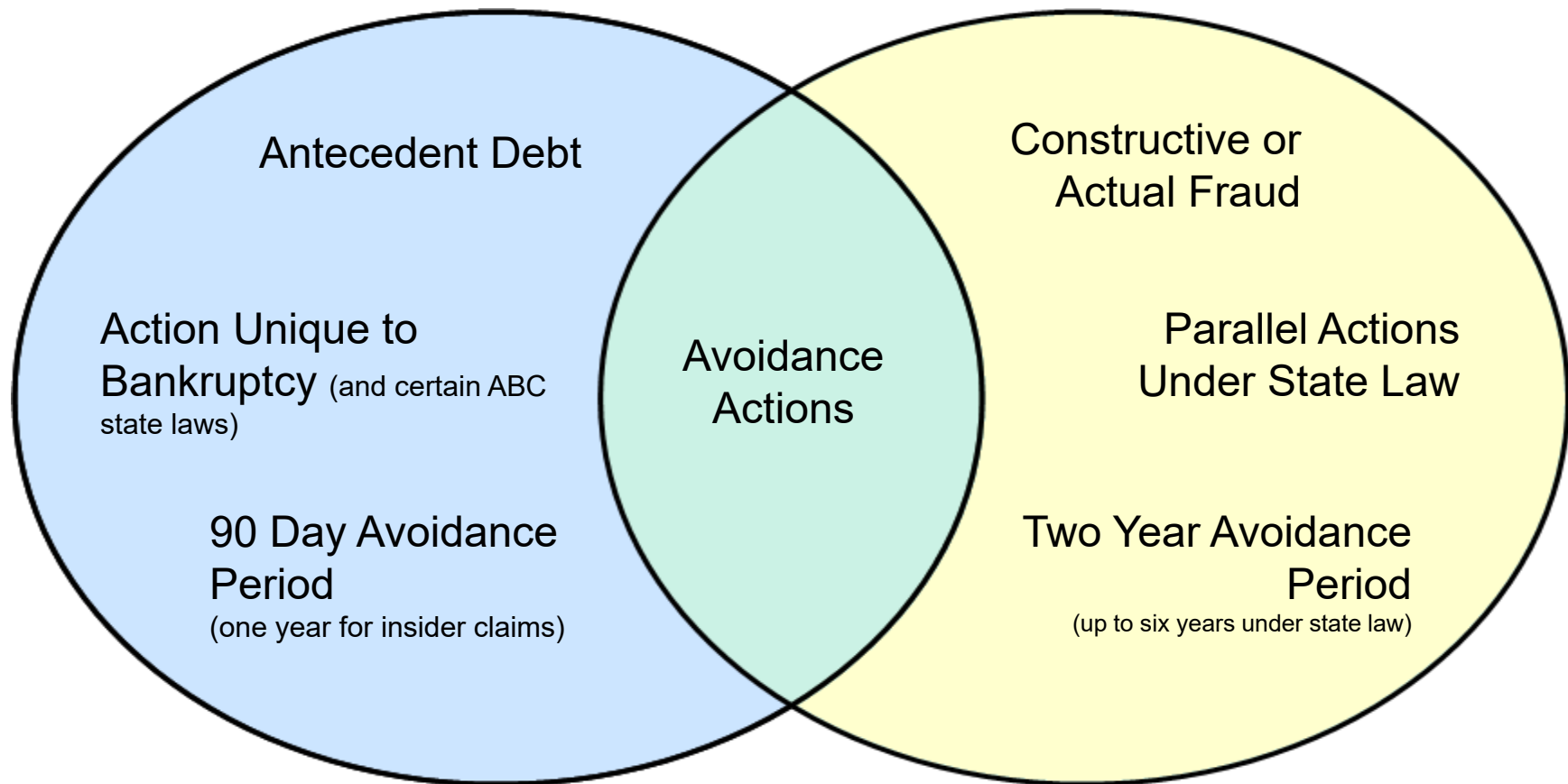
Constructive Fraudulent Transfer

- Unlike intentional fraud, constructive fraud actions do not take the Debtor's intent into consideration
- Under constructive fraud, a transfer is deemed fraudulent if:
 - Debtor received **less than reasonably equivalent value** in exchange for the transfer, **and**
 - Debtor was:
 - Insolvent on the date of the transfer or became insolvent as a result of the transfer,
 - The Debtor was engaged or about to engage in a business transaction for which property remaining with the debtor was an unreasonably small capital, or
 - The Debtor intended to incur or believed that it would incur debt that would be beyond the Debtor's ability to repay as such debts matured

Preference v. Fraudulent Transfer

Preference

Fraudulent Transfer



State Law Fraudulent Transfer Claims

- Section 544 does not contain substantive provisions of its own -- it is designed to bring in state law claims. *See Securities Investor Protection Corp. v. Stratton Oakmont Inc.*, 234 B.R. 293, 310 (Bankr. S.D.N.Y. 1999).
- It allows the Trustee to "step into their shoes" and bring claims belonging to unsecured creditors, if at least one unsecured creditor exists.

Bankruptcy Appeals

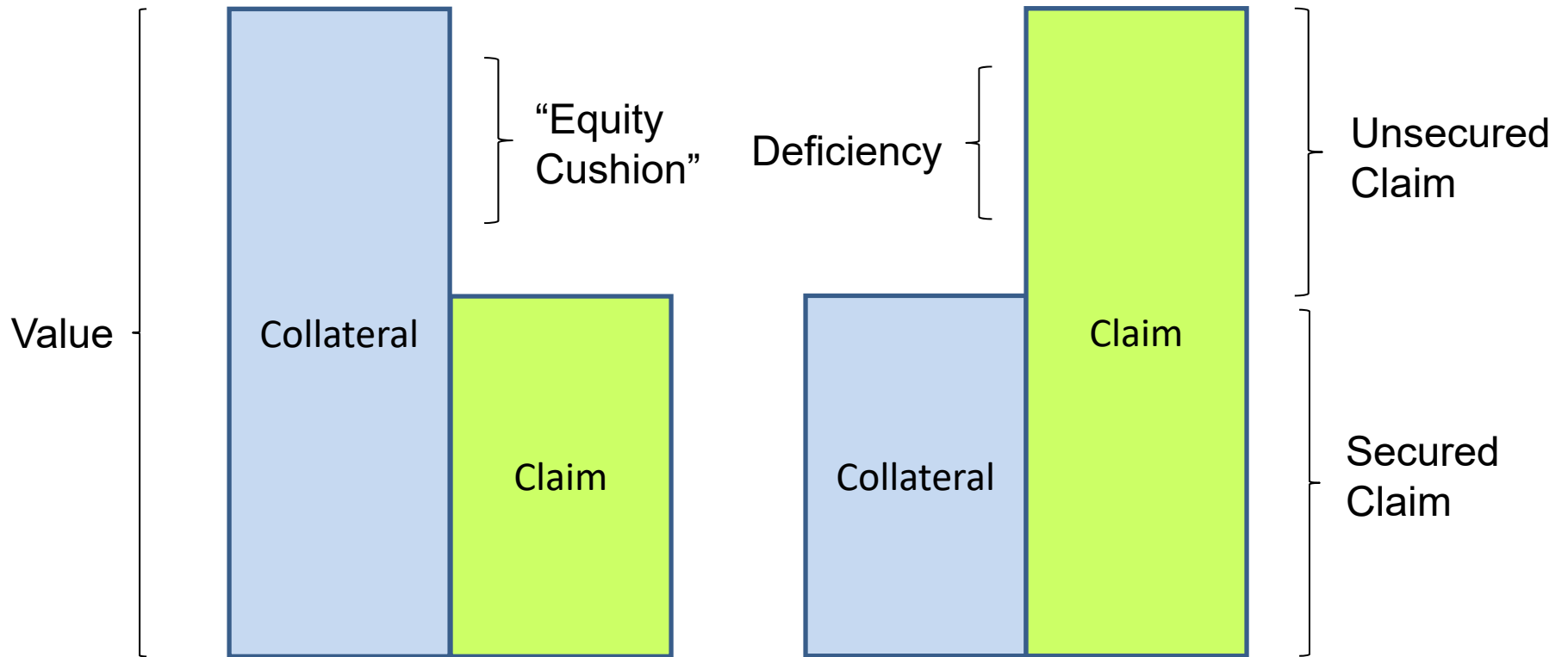


SECURED CLAIMS AND FINANCING ISSUES

Secured Claim

Oversecured

Undersecured



Validity & Priority of Secured Claim

- Perfecting Liens & “Strong-Arm Powers” (§ 544(a))
- Statutory liens
 - Bankruptcy Code allows for the post-petition perfection of certain liens
 - Creditor must have an interest in the property that would be effective against an entity that acquires the property before the date of perfection
 - Bankruptcy Code provides if the applicable statutory lien law requires seizure of the property or commencement of an action to accomplish perfection then the interest can be perfected in bankruptcy by filing a certain notice with the bankruptcy court (§ 546(b))
 - Otherwise statutory liens are invalid or avoidable (§ 545)
- Stipulations & Lien Challenge Periods

Cash Collateral

- Definition: Security interest in cash and other cash equivalents
 - Governed by Uniform Commercial Code
 - Includes deposits at lender's bank, cash subject to account control agreement
- Cash collateral in bankruptcy
 - Liens may extend to proceeds, products, offspring, profits or rents acquired by the debtor after the petition date from the pre-petition secured property, depends on documentation and perfection
 - Use of cash collateral requires either (i) **consent** of secured creditor, or (ii) demonstration that secured creditor is **adequately protected** (at a bankruptcy court hearing)

“Adequate Protection”

“Adequate Protection” Defined: The right of a secured claim holder, during a bankruptcy case, to protection against a decrease in the value of its interest in the debtor’s collateral that secures its debt

Types:

- Periodic cash payments
- Additional or replacement liens
- Maintenance expenses and insurance
- Professional fees

DIP Financing

DIP Financing or DIP is short for Debtor in Possession Financing

Typically done on secured basis

Section 364 of the Bankruptcy Code allows debtor to offer higher priority to DIP lenders over existing lenders in certain circumstances

- Superpriority over all administrative expenses (§ 364(c)(1))
- Priming liens on previously encumbered assets (§ 364(d))

Priming Liens

A debtor can obtain new credit or incur debt secured by a senior or equal lien on property of the estate that is already subject to a lien if the debtor shows two things:

- (1) the debtor is unable to obtain such credit otherwise; and
- (2) the interests of the current lien holder will be "adequately protected" should the proposed senior or equal lien be granted

More difficult to obtain authorization without consent of prepetition secured creditor(s) (must prove adequately protected; priming fights are rare)

Prepetition lenders sometimes "rolled up" into DIP

Loan to Own

- Investor purchases exiting debt of a troubled entity or funds a distressed entity with new financing
- Objective is to obtain a high return on loan/financing or to convert debt obligation into controlling position in equity of company
- Potential pitfalls:
 - Valuation fights
 - Avoidance actions (liens and claims)
 - Costs of chapter 11
 - Potential long-term commitment of capital
 - Relatively illiquid investment
 - Equitable subordination
 - Recharacterization
 - Equitable disallowance
 - Lender liability
 - Vote designation