Basic Business Bankruptcy Issues:
A Primer For In-House Counsel

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BASIC BUSINESS BANKRUPTCY ISSUES: A PRIMER FOR IN-HOUSE COUNSEL

This primer is intended to provide guidance on basic business bankruptcy issues to in-house counsel with a limited background in bankruptcy matters. It is not intended as a substitute for legal advice on commercial insolvency matters or underlying state law issues. This primer should therefore serve only as a starting point of reference to assist in-house counsel with identification of issues and concepts that frequently arise in the context of corporate insolvency proceedings under the United States Bankruptcy Code.  

I. Types of Business Bankruptcy Cases And Key Players

Chapter 11

A company may elect to restructure and reorganize its business under chapter 11 of the Bankruptcy Code. Upon the filing of a voluntary petition under chapter 11, an “order for relief under chapter 11” is deemed to be entered. An “estate” is immediately deemed to arise consisting of all of the assets of the company as of the date of the petition. In the case of an involuntary filing, discussed below, the estate is created upon the court’s granting of the involuntary petition and entry of the order for relief.

A company is not required to be insolvent in order to file for chapter 11 relief and may elect to use chapter 11 in order to effectuate a financial (balance sheet) restructuring, an operational restructuring, a combination of both, or a liquidation. Each of these approaches is briefly summarized as follows:

Specifically, chapter 11 can enable a business debtor to implement a balance sheet restructuring by reducing a reorganized company’s debt burden to better align with its ability to generate cash flows to service debt. This often involves a plan of reorganization that converts all or a portion of existing secured and unsecured debt to new equity in the reorganized debtor, effectively cancelling old equity interests. Although less frequent, old equity holders may be permitted to continue to participate in the reorganized debtor, with either warrants or a substantially diluted equity position.

A business debtor can also implement an operational restructuring of its business model in chapter 11. This can involve rejecting burdensome executory contracts and leases, selling unprofitable business units, and streamlining operations to yield a more efficient business model.

A chapter 11 case can also be used to implement an orderly liquidation of a company, with management remaining in control throughout the liquidation process. This can involve management’s sale of substantially all the assets of the company in one or more sales under section 363 of the Bankruptcy Code, discussed below. It can also involve the formation of a liquidation trust to pursue causes of action or market and sell

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2 11 U.S.C. § 301(b).
illiquid assets for the benefit of creditors over a period of time after a liquidation plan is confirmed.

Generally, a debtor may convert a chapter 11 case into a chapter 7 liquidation case, discussed below, at any time with three exceptions: (i) if a trustee has been appointed; (ii) the case was commenced as an involuntary case, discussed below, or (iii) the case was converted to a chapter 11 case at the request of someone other than the debtor. Also, in some circumstances, the court must convert the chapter 11 case to a case under chapter 7 upon a showing of “cause,” including diminution of the estate and the absence of a reasonable likelihood of rehabilitation, gross mismanagement of the estate, or failure to comply with a court order.

Chapter 7

A company may elect to be liquidated by a trustee under chapter 7 of the Bankruptcy Code. Immediately upon commencement of a case under chapter 7, a trustee is appointed to administer all of the assets of the company’s estate. The trustee is responsible for collecting and liquidating all assets and for eventually making distributions to creditors holding allowed claims against the estate. The trustee is also responsible for reviewing all claims asserted against the estate, consenting to the allowance of claims, and objecting to claims as appropriate. The trustee is authorized to pursue and defend any pending litigation and to file new lawsuits on behalf of the company and the estate, including legal actions under the Bankruptcy Code to recover preferences and fraudulent transfers, discussed further below. The trustee’s goal is typically to fully administer the estate and make distributions to creditors holding allowed claims on a pro rata basis in accordance with the statutory priorities of claims. A typical chapter 7 case may take from six months to two years to complete, depending upon the size and complexity of the case. Some mega-cases like that of Lehman Brothers Holdings, Inc. and its affiliates, one of the largest chapter 7 filings in history, can take a substantially longer time to fully administer not only because of the sheer size of the case but also because of complex cross-border implications.

An empirical study of 449 bankruptcy liquidations in 1994 supports the view that liquidations under chapter 7 tend to result in lower recoveries for unsecured creditors than chapter 11 liquidations. The study analyzed 247 chapter 7 cases and 202 chapter 11 cases and reported that unsecured creditors received an average of .751 cents on the dollar in chapter 7 liquidations versus 20.803 cents on the dollar in chapter 11 liquidations where a plan was approved and 9.33 cents on the dollar where the case was later converted to chapter 7. On average, the chapter 11 liquidations also took half as long (one year) as those in chapter 7 (two years), except in cases where there was a conversion (more than five years). Of course, exceptions abound.

Involuntary Petitions

In a typical business case that involves a company with more than 12 creditors, an involuntary petition may be filed by three (3) creditors in order to force the business debtor into a

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4 11 U.S.C. §§ 1112(a); 706(a).
7 Id. at 83.
chapter 11 or chapter 7 proceeding. Each of the creditors must hold a claim that is not contingent as to liability or the subject of a *bona fide dispute* as to liability or amount, and the creditors must hold unsecured claims totaling at least $12,300 in the aggregate. If the company has less than 12 creditors (excluding insiders, employees and transferees of voidable transfers), the involuntary petition may be filed by one unsecured, non-insider creditor meeting the same criteria.

Typically, an involuntary petition would be filed by creditors seeking to force a liquidation proceeding under chapter 7. The debtor may contest the petition or may simply elect to convert to a case under chapter 11. If the debtor contests the involuntary petition, the court may enter an order for relief only after finding that: (i) the debtor is generally not paying its debts as they become due (unless the debts are the subject of a *bona fide dispute*); or (ii) within 120 days before the filing, a custodian (such as an assignee for the benefit of creditors) was appointed to administer substantially all of the debtor’s assets.

The time frame that typically elapses between the date an involuntary petition is filed and the order for relief is granted is colloquially referred to as the “gap period.” During this time, the debtor may continue to operate its assets and affairs as if the involuntary petition had not been filed, but has the benefit of protections under the automatic stay, as discussed below.

While the filing of an involuntary petition against an uncooperative debtor may have some appeal, it is not to be undertaken lightly. If the court dismisses the involuntary petition other than with the consent of the petitioners, the court may award the debtor costs, reasonable attorneys fees, and, in the case of a petition found to have been filed in bad faith, the court may award any damages proximately caused by the involuntary filing and punitive damages.

*The Key Players*

In a chapter 11 case, there are certain key players with prominent roles, while in a chapter 7 case, the key players are typically limited to the trustee appointed to liquidate the case, the Office of the U.S. Trustee and individual creditors. The typical key players in a chapter 11 case are:

**The U.S. Trustee**

The Office of the United States Trustee, a division of the Department of Justice (the “U.S. Trustee”), is charged with oversight of the bankruptcy system. A local representative of the U.S. Trustee is typically assigned to monitor every chapter 11 case.

The U.S. Trustee is responsible for the appointment of statutory committees of creditors and equity holders in a chapter 11 case, typically comments on applications to retain professionals, and can be heard on any issue in the case. The U.S. Trustee typically intervenes to

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ensure compliance with the operating and reporting rules promulgated by the U.S. Trustee and concerns regarding overall fairness to creditors.

The Creditors’ Committee

If a creditor must suffer the fate of being a “mere unsecured creditor” in a bankruptcy case, bare of any priority or security interests, it should consider participating in the official committee of unsecured creditors that is appointed in almost every chapter 11 case (the “Creditors’ Committee”).

The U.S. Trustee typically appoints a Creditors’ Committee consisting of members that are willing to serve, and hold the seven largest claims against the debtor. The U.S. Trustee usually sends out invitations to serve to the debtor’s 20 largest unsecured creditors, as listed on the petition filed by the debtor, and selects among the largest holders that respond in the affirmative.

Members of the Creditors’ Committee serve as fiduciaries for the interests of all creditors during the case and are reimbursed for out-of-pocket expenses incurred. They have a statutory duty to maintain the confidentiality of non-public information received as a member of the committee. So long as members act within the scope of their duties, they face no individual liabilities for their actions. The Creditors’ Committee may retain counsel, and sometimes financial advisors, at the expense of the debtor’s estate to represent the interests of unsecured creditors during the case. The main benefits of serving on the Creditors’ Committee include having the opportunity to influence the outcome of the case through participation in plan negotiations and in other key events during the bankruptcy case, gaining access to more meaningful information as part of the committee’s monitoring of the debtor’s business activities, and having legal fees paid by the debtor’s bankruptcy estate.

The Equity Committee

In certain cases, except in cases where a debtor is deemed to be hopelessly insolvent, the U.S. Trustee may appoint an official committee of equity security holders, typically consisting of holders of the seven largest amounts of equity securities of the debtor (the “Equity Committee”). Courts often agree to appoint Equity Committees in cases where management has substantial conflicts that prevent them from adequately representing equity holders.

The members of the Equity Committee also serve as fiduciaries during the chapter 11 case, but act on behalf of holders of equity securities. Members of the Equity Committee are entitled to retain counsel and financial advisors at the expense of the debtor’s estate. Studies

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17 See e.g., Albero v. Johns-Mansville Corp. (In re Johns-Mansville Corp.), 68 B.R. 155, 160 (S.D.N.Y. 1986) (purpose of equity committees is to counteract the tendency of a debtor to pacify large creditors at the expense of small and scattered public investors).
have shown that where Equity Committees are appointed, equity holders have greater recoveries than in cases where no Equity Committee is appointed.\textsuperscript{18}

Other Parties

In some cases, active players can include individual creditors or a committee of bondholders, secured creditors, unions, and parties to critical executory contracts.

II. Fundamental Bankruptcy Concepts

The Automatic Stay

The automatic stay arises immediately upon the filing of a voluntary (or involuntary) petition for relief under chapter 7 or 11, without need of further court action.\textsuperscript{19} The automatic stay is the most fundamental protection provided to debtors under the Bankruptcy Code, and is intended to allow a debtor or trustee the “breathing room” to focus on implementing a reorganization or liquidation and to prevent creditors from improving their position or standing \textit{vis a vis} other similarly situated creditors.

Similar to a self-effectuating statutory injunction, the automatic stay prohibits third parties from taking any action against the debtor or against property that is deemed to be property of the estate. Any pending litigation, collection efforts, foreclosure proceedings or similar actions are immediately stayed. Even sending a default notice or verbally threatening action against the debtor is a violation of the automatic stay.

Wilful violations of the automatic stay by third parties that are on notice of the commencement of the bankruptcy case can result in penalties and fines under section 362(k)(1) of the Bankruptcy Code.\textsuperscript{20} While on its face section 362(k)(1) applies to violations by individuals, some courts have applied it to corporations and partnerships that willfully violate the automatic stay.\textsuperscript{21}

Unless modified by court order, the automatic stay remains in place throughout the pendency of the bankruptcy case. In most cases, debtors incorporate some form of continuation of the automatic stay and its injunctive effect in the provisions of their proposed plan of reorganization.

Any party considering adverse action against a debtor should therefore presume the automatic stay is in effect and first consult with counsel on how to obtain relief from the bankruptcy court. Generally, secured creditors may seek relief from the automatic stay on the basis that their collateral is eroding in value and the debtor is not protecting their collateral from erosion thereby entitling them to adequate protection or relief from the automatic stay.\textsuperscript{22}


\textsuperscript{19} 11 U.S.C. § 362(a).

\textsuperscript{20} 11 U.S.C. § 362(k)(1).


\textsuperscript{22} 11 U.S.C. § 362(d)(1).
Adequate protection may consist of monthly cash payments to compensate for any erosion in value of the collateral, additional or substitute liens on other collateral, or other negotiated protections. Creditors may also seek relief from the automatic stay on the grounds that the debtor lacks equity in the subject property and that the property is not necessary to an effective reorganization.\(^{23}\)

If a case involves a “single asset real estate” debtor, the automatic stay automatically terminates within 90 days unless the debtor has filed a plan with a reasonable possibility of being confirmed within a reasonable amount of time.\(^{24}\) “Single asset real estate” means real property constituting a single property or project which generates substantially all of the gross income of a debtor on which no substantial business is being conducted by a debtor other than the business of operating the real property and incidental activities (e.g., shopping centers, commercial office buildings, hotels, and the like).\(^{25}\)

**Property of the Estate**

The automatic stay does not extend to property unless it is deemed to be “property of the estate.” Therefore, a key line of inquiry at the outset of any bankruptcy matter is to confirm that the property at issue is property of the estate. As a basic matter, section 541(a) of the Bankruptcy Code states that “all legal or equitable interests of the debtor in property as of the commencement of the case” constitute property of the estate.\(^{26}\) This language in turn is well understood to require an analysis of the debtor’s interest in the subject property as of the petition date under applicable state law.\(^{27}\)

An important limitation to consider is set forth in section 541(d) of the Bankruptcy Code which provides that “[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest,….. becomes property of the estate….. only to the extent of the debtor’s legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.”\(^{28}\) This express limitation can be of critical importance in crafting escrow arrangements and other creditor protections, as discussed below.

**Priority of Claims**

The term “claim” is broadly defined and includes a right to payment or a right to an equitable remedy for a failure of performance if the breach gives rise to a right of payment.\(^{29}\) The Bankruptcy Code requires any distributions to creditors in chapter 11 or chapter 7 to be made in accordance with the relative priorities of such claims in the following order:\(^{30}\)

(i) Secured creditors - individuals or entities holding claims against the debtor that are secured by a lien on property of the debtor.


\(^{26}\) 11 U.S.C. § 541(a).


\(^{28}\) 11 U.S.C. § 541(d).

\(^{29}\) 11 U.S.C. § 101(5).

\(^{30}\) 11 U.S.C. §§ 507(a), 726(a).
(ii) Unsecured creditors entitled to priority - individuals or entities holding claims incurred during the administration of the chapter 11 case that were necessary or benefited the preservation of the debtor’s estate (“administrative expenses”), certain reclamation claims, and other claims having statutory priority over other unsecured creditors (e.g., certain wages, pensions, taxes). These claims are typically required to be paid in full unless there is an administrative insolvency.

(iii) General unsecured creditors - individuals or entities holding allowed unsecured claims. These claims are typically paid on a pro rata basis from funds available after payment of secured and administrative claims.

(iv) Equity security holders - individuals or entities holding interests in equity securities of a debtor (e.g., stock in a corporation). These interests are last in line and are entitled to a recovery only after payment to the senior classes of creditors in a liquidation scenario.

**Executory Contracts**

Under section 365 of the Bankruptcy Code, the trustee or debtor has the right to “assume or reject” any “executory contracts” of the debtor as of the commencement of the case. The term “executory contract” is broadly defined as a contract under which “the obligation of both the bankrupt entity 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 from the other.”

The standard for assuming or rejecting executory contracts is the “business judgment” standard. Courts generally give the debtor or trustee wide discretion in articulating a sound business reason for either assuming or rejecting an executory contract.

The resulting ability to cherry-pick contracts for assumption or rejection is a powerful weapon for debtors in bankruptcy. Even though the contract party is protected by the fact that an executory contract must be assumed or rejected as a whole, a debtor may credibly threaten to reject a contract in order to compel a renegotiation of unfavorable terms.

In the case of a trustee, assumption would typically be intended for the purpose of assigning the contract to a third party in exchange for some compensation to the estate. A debtor, in contrast, may assume a contract for itself or for the purpose of assigning it to a third party.

The ability to assign executory contracts is enhanced in bankruptcy because anti-assignment clauses are not enforceable except in limited circumstances. Generally, anti-assignment clauses are enforceable only if the contract cannot be assigned under applicable non-

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33 Orion Pictures Corp. v. Showtime Networks, Inc. (In re Orion Pictures Corp.), 4 F.3d 1095, 1099 (2d Cir. 1993).
34 11 U.S.C. §§ 365(f); 365(c).
bankruptcy law, such as in the case of personal service contracts, non-exclusive intellectual property licenses, government contracts and contracts to make a loan or to issue securities of the debtor which can not be assumed in the first instance.

The outcome is not always certain or consistent with respect to assumption or assignment of certain types of executory contracts. For example, even though some courts permit assignment of exclusive intellectual property licenses, the Ninth Circuit has held that exclusive copyright licenses are not assignable and that the debtor may not assume (or assign) such contracts. Bankruptcy courts are also split as to whether a debtor is permitted to assume an executory contract in the first instance if the contract is not assignable under state law. Another area subject to inconsistent rulings involves franchise or distributorship contracts and the degree to which they can successfully be characterized as involving unique characteristics or relationships akin to personal service contracts. For example, in the context of exclusive distributorship agreements, bankruptcy courts have found that a contract could not be assumed to a competitor of the nondebtor contract party, contrary to Section 2-210(2) of the Uniform Commercial Code (“UCC”), where the contract required the debtor to make best efforts to perform, because the contract party did not bargain for the best efforts of its competitor.

Assuming a contract is assumable and assignable, the debtor must “cure” any defaults and pay any outstanding amounts due prior to assumption. Nonmonetary defaults must also be cured, except with respect to commercial real estate leases where such defaults are not required to be cured if doing so is impossible. However, the debtor is still required to pay for any monetary losses arising from the prior failure to perform and to comply with lease obligations post-assumption. Importantly, the nondebtor contract party is entitled to receive adequate assurance of future performance of the contract from the debtor or the proposed assignee.

If a contract is rejected, the contract party is left with an unsecured claim for breach of contract effective as of the date the case was commenced. Certain contract parties may retain

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35 Generally contracts entered into on the basis of the “character, reputation, taste, skill or discretion of the party to that is to render performance.” 3 E. Allan Farnsworth, Farnsworth on Contracts §11.10, at 129 (1990).
36 See e.g., In re CFLC, Inc., 89 F.3d 673, 677 (9th Cir. 1996) (non-exclusive patent license not assignable); In re Golden Books Family Entertainment Inc., 269 B.R. 311 (Bankr. D. Del. 2001) (non-exclusive copyright licenses non-assignable).
37 In re West Electronics, 852 F.2d 79 (3rd Cir. 1988) (federal contracts not assignable under the Federal Anti-Assignment Act, 41 U.S.C. § 15).
40 Gardner v. Nike, 279 F.3d 774 (9th Cir. 2002).
43 Sally Beauty Co., Inc. v. Nexxus Products Co., Inc. 801 F.2d 1001, 1006 (7th Cir. 1986).
rights under the rejected contract. Specifically, tenants in possession and licensees of intellectual property may retain certain rights with respect to the property/license at issue. Nevertheless, such parties must remain alert because their rights may be extinguished in a sale under section 363(f) of the Bankruptcy Code if the contract party receives notice of the proposed sale free and clear of its interests and it does not timely object. Section 363 sales are discussed below.

Pending a decision to assume or reject an unexpired personal property lease in a chapter 11 case, the lessor is entitled to an administrative expense for payments due during the first 60 days of a chapter 11 case (i) if the lessor can show there was a benefit to the estate from the use of the equipment during that time, or (ii) for payments arising between the 60th day after the order for relief and rejection, regardless of whether any benefit was conferred. Section 365(d)(5) of the Bankruptcy Code requires the debtor in a chapter 11 case to automatically perform obligations under unexpired personal property leases that arise on or after 60 days following the order for relief, unless the court holds a hearing at the debtor’s request and determines otherwise, with the burden of proof on the debtor. In addition, under section 503(b)(1) of the Bankruptcy Code, the debtor may be required to make payments due during the first 60 days of a bankruptcy case upon a showing that the estate benefitted from the use of the personal property during that time. Effectively, this permits the debtor to use the first 60 days to reject personal property leases without incurring administrative expense liabilities for those leases where the subject personal property is not used and does not benefit the estate. In comparison, in a chapter 7 case, section 365(d)(5) of the Bankruptcy Code does not apply, and a trustee is not required to pay obligations under an unexpired personal property lease pending assumption or rejection unless the lessor establishes, as required under section 503(b)(1) of the Bankruptcy Code, that the use of the property benefitted the estate during that time.

Commercial real estate leases are subject to altogether different rules for performance of obligations pending assumption or rejection. The debtor/trustee must automatically perform the obligations arising under expired non-residential real property leases commencing from the order for relief, although the court may defer performance to the end of the 60 day period. Therefore, a debtor wishing to avoid automatic administrative rent liability for a non-residential real estate lease must reject the lease immediately after commencement of its chapter 11 case.

With respect to timing for assumption or rejection, if a chapter 7 trustee does not assume an executory contract within 60 days after the petition date, the contract is deemed rejected. In contrast, debtors have until confirmation of a plan to decide whether to assume or reject an executory contract, and so debtors will typically defer a decision as long as possible until confirmation, unless they reject early in order to avoid the administrative expense obligations discussed above.

47 11 U.S.C. §§ 365(n), 365(h).
48 See e.g., Precision Industries, Inc. v. Qualitech Steel SBQ LLC (In re Qualitech Steel Corp.), 327 F.3d 537 (7th Cir. 2003).
49 11 U.S.C. § 365(d)(5) (applicable to a debtor or trustee in a chapter 11 case).
Again, commercial real estate leases benefit from a different rule in that they must be assumed or rejected within a fixed time not to exceed 210 days from the commencement of a bankruptcy case. The debtor has an initial 120 days to assume or reject, subject to one 90-day extension unless the landlord consents to additional time. If a real estate lease that was assumed is later breached by the debtor, the administrative expense that the landlord can claim is subject to a cap of two years’ rent.\(^{54}\)

If a trustee or debtor is not acting promptly to assume or reject a contract, a party to the contract may request the bankruptcy court to set an earlier deadline based upon the facts and circumstances particular to that party.\(^{55}\) That party may also seek adequate protection for its lease interests pending assumption or rejection.\(^ {56}\) For example, courts have found that a lessor of personal property is entitled to an administrative expense for damage to the subject equipment during the first 60 days of a chapter 11 case if the lessor can show there was a benefit to the estate from the use of the equipment, or if the damage occurred between the 60th day after the order for relief and rejection.\(^ {57}\) A lessor of personal property concerned about damage, theft, or stripping of leased equipment should therefore make a prompt request for adequate protection of its interests during the first 60 days of a chapter 11 case in the form of rent payments, allowance of an administrative claim, and/or appropriate equipment protective measures, pending the assumption or rejection of its lease.

A party to an unexpired executory contract dealing with a debtor counter-party facing an imminent or threatened bankruptcy should consider terminating the contract in accordance with its own terms prior to the bankruptcy in order to avoid being subject to the automatic stay. Except for safe harbor provisions for certain financial and derivative contracts,\(^ {58}\) once the bankruptcy case is commenced, the creditor will be stayed from terminating an unexpired executory contract. In contrast, an executory contract properly terminated prior to the commencement of the bankruptcy case cannot be assumed. If the contract is not properly terminated, under either the contract or applicable law, however, the debtor may asserts claims for wrongful termination and seek to reinstate the contract as property of the estate.

Section 363 Sales

Another powerful tool in bankruptcy is the ability to sell assets free and clear of all pre-bankruptcy liens, claims and interests with such liens, claims and interests attaching to the proceeds of sale at closing under section 363 of the Bankruptcy Code.\(^ {59}\) A debtor in chapter 11 seeking to sell some or all of its assets “outside the ordinary course of business” need only show “good business reason” for such a sale,\(^ {60}\) even if the sale will be tantamount to a liquidation with creditors left to assert their claims against the sale proceeds and any assets excluded from the sale that remain in the estate.

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\(^{56}\) 11 U.S.C. § 363(e).
\(^{57}\) See e.g., In re Hayes Lemmerz International, 340 B.R. 461 (2006).
\(^{58}\) 11 U.S.C. §§ 362(b)(6), (b)(7), (b)(17), and (b)(27).
\(^{60}\) In re Lionel Corp., 722 F.2d 1063 (2d Cir. 1983).
For a potential purchaser of assets, a sale under section 363 of the Bankruptcy Code provides the best and clearest title in the fastest time frame while also providing bidding protections such as break-up and reimbursement fees similar to those available outside of bankruptcy. Courts differ, however, on the standards used to review and approve bid protections. Therefore, it is important to consult with bankruptcy counsel as to the applicable local standard.

A section 363 sale can be an effective tool for leaving “bad assets” and “bad liabilities” (e.g. legacy liabilities, mass tort claims, and successor liability claims) behind in the estate while allowing the purchaser to acquire only the valuable assets and related necessary operational liabilities such as those for necessary vendors and executory contracts that the purchaser chooses to assume.

With respect to liens held by secured creditors, under section 363(f)(3) of the Bankruptcy Code, the proposed sale price must be “greater than the aggregate value of all liens” on the subject collateral, unless the secured creditor’s interest is the subject of a bona fide dispute or it consents to the sale. However, courts are divided on whether “the aggregate value of all liens” means greater than the face amount of the liens or greater than the value of the subject collateral. This means that in certain jurisdictions, a non-consenting “out of the money” junior lien holder may present an obstacle to a sale free and clear of its lien.

Avoidance Actions

The Bankruptcy Code grants a debtor or trustee the authority to avoid certain transfers and make recoveries for the benefit of the estate. These avoidance powers include the power to:

(i) set aside preferential transfers made to non-insider creditors within 90 days prior to the petition under section 547 of the Bankruptcy Code and with respect to insiders within one year prior to the petition. Generally, “insiders” are directors, officers, general partners of a partnership and other ‘control persons’ or their relatives,

(ii) undo security interests and other pre-petition transfers of property that were not properly perfected under non-bankruptcy law at the time of the commencement of the chapter 11 case as if the debtor or trustee stood in the shoes of a hypothetical perfected judgment lien holder, a bona fide purchaser of real estate or an

unsecured creditor entitled to void transactions under applicable law\(^{67}\) (like the Uniform Fraudulent Transfer Act) as of the petition date;

(iii) recover fraudulent transfers made, generally, (i) within a two-year period prior to the petition date for transfers made with actual intent to hinder, delay, or defraud creditors;\(^ {68}\) and (ii) within a four-year period prior to the petition for transfers made for less than reasonably equivalent value while the debtor was insolvent, or was rendered insolvent or deemed to have unreasonably small capital;\(^ {59}\) and

(iv) pursue state law claims such as bulk transfer claims and other remedies available under state law, including reaching back more than four years to recover fraudulent transfers as permitted by state law.\(^ {70}\)

**Fraudulent Transfers**

With respect to fraudulent transfers, some basics concepts that are important to understand include:

(i) There are two types of recoverable fraudulent transfers - transfers that are deemed made with “actual fraud” and transfers that are deemed “constructive fraudulent transfers”:

   (a) In determining whether a fraudulent transfer was made with “actual intent to hinder, delay, or defraud creditors,”\(^ {71}\) courts looks to the facts of the case to discern the presence of certain “badges of fraud,” including whether: the transfer was to an insider, the debtor retained possession or control of the property allegedly transferred, the transfer was concealed, the debtor absconded, the transfer was of all the debtor’s assets, the debtor was insolvent or rendered insolvent, there was pending or threatened litigation, and the debtor received less than reasonably equivalent consideration.\(^ {72}\)

   (b) Transfers are deemed “constructive fraudulent transfers” if they meet the following elements: (1) the debtor received less than “reasonably equivalent value” in exchange for the transfer or obligation; and (2) the debtor meets *one of the following three insolvency tests*: (i) it was insolvent at the time, or became insolvent as a result of the transfer; (ii) it was engaged (or was about to engage) in a business or transaction for which any property remaining was unreasonably small capital; or (iii) it intended to incur, or believed it would incur debts beyond its ability to pay.\(^ {73}\) Insolvency means “balance sheet insolvency” -

\(^{67}\) 11 U.S.C. § 544(b); see Moore v. Bay, 284 U.S. 4 (1931) (trustee standing in the shoes of an unpaid unsecured creditor entitled to set aside entire transaction; not just to the extent of the unpaid creditor’s claim).


\(^{70}\) 11 U.S.C. § 544(b).


\(^{73}\) See e.g., Kelly v. Armstrong, 206 F.3d 794 (8th Cir. 2000); Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d 1248 (1st Cir. 1991).
meaning liabilities exceed assets at a fair valuation, excluding the property transferred\footnote{11 U.S.C. § 101(32).} for purposes of the first insolvency test.

(ii) Reasonably equivalent value generally includes any type of direct or indirect value received by the debtor in exchange for the transfer or obligation, including payment or relief from obligations to pay antecedent debts, but does not include promises to provide support in the future to either the debtor or a relative of the debtor.\footnote{11 U.S.C. § 548(d)(2)(A).}

(iii) Not surprisingly, disputes concerning the insolvency element of an alleged fraudulent transfer can lead to protracted and expensive litigation. Courts generally look at a combination of valuation methodologies to determine valuation for insolvency purposes, including: (a) actual sale price; (b) discounted cash flow method, commonly referred to as DCF; (c) adjusted balance sheet method; (d) market multiple approach; (e) comparable transaction analysis; and (f) market capitalization.\footnote{Statutory Comm. on Unsecured Creditors on behalf of Iridium Operating, LLC, et al. v. Motorola Inc. (In re Iridium Operating LLC), 373 B.R. 283, 345 (Bankr. S.D.N.Y. 2007).} The post-transaction market valuation of the company has been found to be the most compelling evidence of solvency notwithstanding competing expert testimony on various valuation approaches.\footnote{Id. at 347 (citing VFB LLC v. Campbell Soup Co., 482 F. 3d 624 (3rd Cir. 2007).} In determining capital adequacy, courts look to such factors as the company’s debt-to-equity ratio, its historical capital cushion, and the need for working capital in the specific industry at issue.\footnote{Id. at 345.} Generally, contingent liabilities are typically determined by taking the face value of the liability and multiplying it by the probability that the contingency will occur (e.g., $100 million guaranty liability x 20% probability of collection = $20 million claim). Parties can therefore disagree and litigate not only about the various valuation methodologies, but also the probabilities affecting contingent obligations.

(iv) Sophisticated commercial transactions, including leveraged buy-outs, can be attacked as fraudulent transfers with inconsistent results.\footnote{See e.g., MFS/Sun Life High Yield Series v. Van Dusen Airport Services Co., 910 F. Supp. 913 (S.D.N.Y. 1995) (LBO structure is unlikely to satisfy fair value requirement); Mellon Bank v. Metro Communications, Inc., 945 F.2d 635 (3rd Cir. 1991), cert. denied, 503 U.S. 937, 112 S. Ct. 1476, 117 L.Ed.2d 620 (1992) (there is no per se rule that LBO renders target insolvent and subject to fraudulent transfer attack); United States v. Tabor Realty, 803 F.2d 1288 (3rd Cir. 1986) (LBO set aside as intentional fraudulent transfer); Kupetz v. Wolf & Vine, 845 F.2d 842 (9th Cir. 1988) (LBO not a fraudulent transfer).}

(v) It may be surprising, but charitable contributions are insulated from claims of fraudulent transfer if they meet certain criteria: (a) the contribution must be less than 15 percent of the debtor’s gross annual income; or (b) if higher, the transfer is consistent with the debtor’s prior practices.

(vi) Transferees that take for value and in good faith may retain a lien on or may retain the property transferred, or may enforce any obligation incurred to the extent they
gave value to the debtor. The Bankruptcy Code does not define good faith but courts generally agree that good faith under section 548(c) must be determined according to an ‘objective’ or “reasonable person” standard, and not based on any subjective knowledge or belief of the transferee. Thus, courts look to what the transferee objectively knew or should have known. This means a transferee in a transfer made with alleged actual fraudulent intent cannot be a good faith transferee if the circumstances would place a reasonable person on inquiry of a debtor’s fraudulent purpose, and a diligent inquiry would have discovered the fraudulent purpose. Therefore, a recipient of a transfer from a ponzi scheme or a fraudulent scheme risks not being a good faith transferee if the circumstances of the redemption or withdrawal indicate the transferee suspected the fraud or would have objectively placed a reasonable person on notice of fraud. In the context of potential constructive fraudulent transfers, a transferee seeking to maximize its good faith status should document its due diligence inquiry as to the debtor’s solvency and obtain a solvency representation from the debtor at the time of transaction.

A full discussion of fraudulent transfer avoidance powers is beyond the scope of this basic primer, however, these are powerful tools in negotiations with secured creditors that may have technical flaws in the perfection of their collateral or that may have participated in pre-bankruptcy leveraged buy-outs, spin-offs, or similar restructuring transactions that may be attacked as fraudulent conveyances.

Preferences

With respect to preferences, the core purpose of preference recovery is to ensure equitable distribution of all property of the estate by permitting the debtor/trustee to recover property from certain creditors who obtained payment of their debts ahead of others and then “re-distribute” that property pro rata among all creditors. Therefore, no element of “wrongdoing” or fraudulent intent on part of either the debtor or the target creditor is required.

The elements of a voidable preference are: (i) a transfer; (ii) of an interest in property of the debtor; (iii) to or for the benefit of a creditor; (iv) on account of an antecedent debt; (v) made while the debtor was insolvent, on or within 90 days before the filing of the petition (the debtor is presumed to have been insolvent during these 90 days); and (v) the transfer enabled the creditor to receive more than it would in a chapter 7 liquidation. This last requirement means that a properly perfected secured creditor is insulated from preference attack where it would have received the same property in a liquidation.

81 See In re Bayou Group LLC et al., 396 B.R. 810, 844 (Bankr. S.D.N.Y. 2008)
82 See e.g., Bayou Group, 396 B.R. at 844-848 (transferees that withdrew funds for reasons unrelated to suspected fraud protected as good faith transferees; others that stated “discomfort” or “concerns” over debtor’s operations were not).
83 See e.g., Jimmy Swaggart Ministries v. Hays (In re Hannover Corp.), 310 F.3d 796 (5th Cir. 2002), cert. denied, 538 U.S. 1032 (2003) (good faith transferee had no way of knowing debtors were insolvent, undertook due diligence and received assurances of solvency).
The most frequently used defenses to a preference action include:

(i) The transfer was made in the ordinary course of business. This defense can be established by showing: (1) the debt was incurred in the ordinary course of business; (2) the payment was made in the ordinary course of business of the debtor and its creditor; or (3) the payment was made in accordance with ordinary business terms. Thus, a creditor can establish either that the payment was made consistent with the history of its dealings with the debtor or consistent with industry practice, as discussed below.

(ii) The transfer was part of a “substantially contemporaneous exchange.” This defense requires the creditor to prove that the transfer was: (1) intended as, and (2) in fact was, a substantially contemporaneous exchange.

(iii) The transfer was offset by subsequent transfers of value, also known as the “subsequent new value defense.” There are varying approaches among courts as to whether the subsequent value can be netted against prior payments or only the immediately preceding payment or whether it must remain unpaid in order to qualify for a setoff against the alleged preference payments.

(iv) The transfer was made on account of a purchase money security interest that was or can be perfected within thirty days of the transaction.

The most frequently used defense, the ordinary course of business defense, merits a further discussion. Courts generally apply a four-part test to determine whether a payment was made in the ordinary course: (1) the length of time the parties were engaged in business; (2) whether the amount or form of the payment differed from the parties’ prior practice; (3) whether the debtor or creditor engaged in any unusual collection or payment activity; and (4) whether the creditor took advantage of the debtors’ deteriorating financial condition. Not surprisingly, courts can reach inconsistent results in applying this test. Some consistent rules that are worth noting include:

- Early repayment under new or accelerated credit terms during the preference period are routinely deemed outside the ordinary course.

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86 11 U.S.C., § 547(c)(2).
87 11 U.S.C. § 547(c)(1).
89 See In re Meredith Manor, 902 F.2d 257 (4th Cir. 1990) (applying a “net-effect” analysis, i.e., total new value/credit extended against total payments); In re Kroh Brothers, 930 F.2d 648 (8th Cir. 1991) (new value credit extended only if not repaid prior to petition); In re Micro Innovations Corp., 185 F.3d 337 (5th Cir. 1999) (new value applied only to the immediately preceding payment)
It is possible for parties to establish their ordinary course is irregular, sporadic or that no amount of time is so idiosyncratic so as to fall outside their ordinary course.\(^93\)

Late payments regularly made prior to the preference period can establish that a late payment during the preference period was made in the ordinary course.\(^94\)

Accepting a payment by wire transfer in order to minimize the risk of falling into the 90-day period can result in a finding that the transfer is outside the ordinary course where wire payments were not the ordinary course between the parties.\(^95\)

A transfer by check is deemed made when the check clears the bank.\(^96\) Thus, a transfer may be within the preference period even if the check was delivered outside the preference period.

A minimum floor of $5,475 is required for recovery of commercial transfers as a preference.\(^97\) In addition, if the subject commercial transaction is less than $10,000, the debtor or trustee must pursue recovery of the preference in the federal district court in which the defendant creditor resides, as opposed to where the bankruptcy case is pending, unless the creditor is an insider.\(^98\)

Special rules apply to determine the date a transfer is made for the filing of security interests. A transfer is deemed to occur when the transaction takes effect between the parties if it is perfected at or within 30 days.\(^99\) It is perfected beyond the first 30 days, the transfer is deemed to be made “when it is perfected.”\(^100\) The transfer is deemed perfected with respect to real estate “when a bona fide purchaser of property….cannot acquire an interest that is superior to the interest of the transferee.”\(^101\) With respect to all other property, a transfer is deemed perfected “when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee.”\(^102\) As a result of the transfer rules, a secured creditor that perfects its security interest more than 30 days after its original transaction and within the 90-day period prior to a bankruptcy filing, will typically have its security interest deemed to be made when perfected and avoided as a preference.

A full discussion of preference remedies against insiders and non-insiders and respective defenses is beyond the scope of this basic primer. However, creditors should be aware that resolution of preference exposure should be a part of any global settlement negotiations with debtors.

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\(^{94}\) See Sulmeyer v. Pacific Suzuki (In re Grand Chevrolet), 25 F.3d 728 (9th Cir. 1994).


\(^{97}\) 11 U.S.C. § 547(c)(9) (as of April 1, 2007).

\(^{98}\) 28 U.S.C. § 1409(b).


\(^{100}\) 11 U.S.C. § 547(e)(2)(B).


Secured Creditor Rights

Generally, secured creditors are entitled to retain their prepetition liens on the same collateral (or the proceeds thereof) and to be paid in full plus interest at their contractual rate of interest, provided there are no defects or grounds for the debtor to seek to avoid those liens (for example, if such liens are unperfected or can be set aside as fraudulent transfers or preferences).

However, a secured creditor’s claim may be bifurcated into a secured and unsecured claim under section 506 of the Bankruptcy Code in cases where the collateral is worth less than the face amount of the secured creditor’s claim. A creditor may avoid the effects of such bifurcation by making an election under section 1111(b) of the Bankruptcy Code to retain the full amount of its lien on the collateral. By making the election, the creditor waives the right to receive any distributions on the unsecured portion of its claim on confirmation of the plan, but retains the hope that it may recover a higher amount if the collateral increases in value after confirmation of the plan.

The intricacies and strategies related to a section 1111(b) election are beyond the scope of this primer. It is worth noting, however, that the secured creditor would typically take into account the likelihood of whether its unsecured claim would enable it to assert a blocking position in the unsecured creditor class thereby preventing the debtor from obtaining the requisite acceptance of at least one impaired class of claims, as discussed below. Such a blocking position would typically enable the secured creditor to gain leverage to negotiate better treatment of its secured claim under the debtor’s proposed plan. Another strategy is to make the election in cases where the debtor’s revenues would be insufficient to make deferred cash payments having a present value equal to the creditor’s fully secured claim, thereby defeating any attempted cram-down of the plan (discussed below).

A secured creditor may seek relief from the automatic stay at any time in the chapter 11 case to commence or continue pre-bankruptcy foreclosure proceedings. State law foreclosure proceedings typically take anywhere from 12 to 18 months to conclude, and in some cases longer, and can be thwarted by the debtor filing for Chapter 11 shortly before, or upon, a foreclosure judgment being obtained.

Debtor in Possession Financing / Priming Liens

A debtor can seek to entice lenders to provide “debtor-in-possession financing” or “DIP Financing,” as it is widely known, with a range of tools that are routinely approved by bankruptcy courts. First, the debtor can offer administrative expense status to a potential lender. Next, if unable to obtain a loan on that basis, the debtor can offer the proposed lender a “super-priority” administrative claim (having priority over all other administrative claims). However, lenders typically require more than a simple administrative priority or super-priority claim in order to lend to a company in a chapter 11 proceeding because they are typically

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reluctant to run the risk of administrative insolvency (insufficient funds to pay administrative
claims in full).

At the next level, the debtor may seek court approval to grant the proposed lender a lien
on its unencumbered assets or secured by a junior lien on property that is already encumbered by
a lien.\textsuperscript{107} Even though general unsecured creditors may object and insist upon a showing of
necessity for a proposed financing that involves granting liens on unencumbered assets, debtors
typically prevail in such cases where they can show a reasonable prospect or likelihood for
reorganization.

At the highest level, a debtor may seek court approval to grant the proposed lender a lien
on encumbered assets that is equal or senior to existing liens. However, in this case, the debtor
must establish “that it is unable to obtain such credit otherwise.”\textsuperscript{108} Further, the debtor must
establish that the existing lender is adequately protected notwithstanding the proposed senior or
“priming” liens. This typically involves consideration of various factors, including: a valuation
of the subject property to assess the nature of any “equity cushion” that may exist, whether the
property is eroding in value, the nature of payments proposed or available, and whether the
debtor has a reasonable prospect for reorganizing.\textsuperscript{109} Typically, existing senior and junior
lienholders would object vigorously to any priming liens on their collateral absent a showing of
how their liens are adequately protected.

III. Basic Chapter 11 Concepts

During a chapter 11 proceeding, a debtor may continue to operate its business and enter
into “ordinary course” transactions as if no bankruptcy case was pending.\textsuperscript{110} The debtor must
seek court approval for “out of ordinary course” transactions such as sales of assets, financing
transactions, or restructuring of leases and contracts outside the ordinary course prior to
confirmation of a plan of reorganization. Any unauthorized “out of the ordinary course”
transactions can be set aside by a party in interest.\textsuperscript{111} At any time, the gross misconduct of the
debtor may lead to the appointment of a trustee or examiner, conversion of the case to chapter 7,
or dismissal of the case.\textsuperscript{112}

The goal of a debtor in chapter 11 is to ultimately file and confirm a plan of
reorganization. A brief description of the plan process is set forth below.

The Disclosure Statement

A debtor is required to prepare and distribute a disclosure statement prior to solicitation
of acceptance of its plan of reorganization. The disclosure statement must contain adequate

\textsuperscript{107} 11 U.S.C. §§ 364(c)(2), (c)(3).
\textsuperscript{109} See e.g., In re St. Petersburg Hotel, Assoc., Ltd., 44 B.R. 944, 946 (Bankr. M.D. Fla. 1984); In re Stoney Creek
\textsuperscript{110} 11 U.S.C. §§ 1107, 1108.
\textsuperscript{111} 11 U.S.C. § 549.
\textsuperscript{112} 11 U.S.C. §§ 1104(a), 1112(b).
information regarding the assets, liabilities, and affairs of the debtor so as to enable the holder of a claim or interest to make an informed judgment about the proposed plan of reorganization.\textsuperscript{113}

The Plan

During the first 120 days after commencement of the chapter 11 case, only the debtor may file a proposed plan of reorganization.\textsuperscript{114} This period of “exclusivity” may be extended by the court for cause to a date that is not more than 18 months after the petition date.\textsuperscript{115} The debtor has an additional 60 days after the filing of its plan to solicit acceptances of the plan from each impaired class.\textsuperscript{116}

If the debtor fails to file a plan of reorganization within the fixed deadline, or if the plan is not accepted by the creditors within the deadline for soliciting acceptances, the debtor loses exclusivity and any party in interest may file its own competing plan of reorganization.\textsuperscript{117} The typical time from the filing of a chapter 11 case to confirmation of a plan of reorganization is 18 months and sometimes up to two years or more in cases where the debtor’s exclusive period has expired and competing plans are at issue. This time can be shortened significantly with the use of a “prepackaged plan,” discussed below.

Contents of a Plan

A proposed plan must meet certain minimum requirements, including it must:\textsuperscript{118}

(a) designate all classes of claims and interests (substantially similar claims or interests must be categorized in the same class),

(b) specify which classes are impaired and not impaired,

(c) specify which classes are entitled to vote (only impaired classes are entitled to vote),

(d) specify the treatment of all classes,

(e) treat all members within a class equally,

(f) provide adequate means to implement the plan, and

(g) not contain any provisions that violate the Bankruptcy Code.\textsuperscript{119}

Plans can provide for a financial or operational overhaul of the debtor’s business that include: (i) sales of assets; (ii) modification or refinancing of secured debt; (iii) assumption or rejection of contracts; (iv) releases in favor of the debtor’s board of directors, management and

\textsuperscript{113} 11 U.S.C. § 1125(a)(1).
\textsuperscript{114} 11 U.S.C. § 1121(b).
\textsuperscript{117} 11 U.S.C. § 1121(c).
\textsuperscript{118} 11 U.S.C. § 1123.
\textsuperscript{119} 11 U.S.C. § 1129(a).
professionals; (v) amendments to the debtor’s corporate charter; (vi) the cancellation of existing stock; (vii) the issuance of new stock; and (viii) the swapping of debt for equity.

Prepackaged Plans

Prepackaged plans can provide a debtor the significant advantages of a chapter 11 case without the protracted delay and substantial expense often associated with a typical bankruptcy case. Usually, the plan and disclosure statement are filed immediately upon commencement of the chapter 11 case and the pre-bankruptcy class acceptances are then used at an expedited confirmation, typically held within 30 to 90 days.

In a prepackaged chapter 11 case, the prospective debtor can negotiate the terms of a plan, acceptances and rejections before initiating a chapter 11 case. Typically, a committee of creditors is formed and counsel is retained to represent those creditors and negotiate the terms of the plan. The debtor may form more than one committee, for example one for bondholders and another for trade vendors. Once committee support is secured, the plan and disclosure statement are sent to impaired classes of creditors for approval with the support and recommendation of the committees.

A prepackaged plan can be an effective tool for persuading dissenting bondholders, for example, to support a restructuring that is likely to be implemented in a chapter 11 case. The risks of a prepackaged plan arise mostly from dissenting creditors that may seek to take action against the debtor or property of the debtor during the plan negotiation process while there are no automatic stay limitations.

Confirmation of the Plan

In order for the bankruptcy court to confirm its proposed plan of reorganization, a debtor must meet all of the requirements of section 1129 of the Bankruptcy Code. These requirements include establishing that:

(a) at least one impaired class has accepted the plan and with respect to any non-accepting class, the requirements for a “cram-down” have been met (see below);

(b) the plan meets the “best interests of creditors test” which requires in essence that each impaired class has either accepted the plan or will receive no less than it would receive in a liquidation under Chapter 7;

(c) the plan is feasible (i.e., is not likely to be followed by a liquidation or need for further reorganization);

(d) the plan was proposed in good faith; and

(e) the plan does not violate any provisions of the Bankruptcy Code.

Voting on the Plan

With respect to an impaired class of creditors, the class is deemed to accept a plan if voting creditors that hold more than two-thirds in dollar amount and more than one-half in number of the claims in the class vote to accept the plan, excluding any votes not solicited or cast in good faith, as determined by the court on request of any party in interest.

“Cram-down”

Provided all of the requirements set forth in section 1129 of the Bankruptcy Code are met, the bankruptcy court may confirm a plan notwithstanding the rejection of the plan by one or more classes of impaired creditors provided the court determines the plan “does not discriminate unfairly” and is “fair and equitable” with respect to each impaired class that has not accepted the plan.\(^{121}\) This is referred to as the “fair and equitable” test required for a “cram-down.” The “fair and equitable” test for a plan cram-down differs for secured creditors, unsecured creditors, and equity holders.

Generally, however, the fair and equitable test for unsecured creditors and equity holders requires that the class receives property of a value equal to the allowed amount of their claims or that junior classes or interests receiving nothing on account of their claims or interests\(^ {122}\) under the so called “Absolute Priority Rule” (discussed below).

With respect to secured creditors, the “fair and equitable” test generally requires that the creditor keep its lien; receive deferred cash payments totaling at least the allowed amount of its lien claim; and, as of the effective date of the confirmed plan, the value of the payments to be made must have a present value equal to at least as much as the secured creditors’ interest in the collateral.\(^ {123}\) A plan may also be deemed fair and equitable with respect to secured creditors if it provides for deferred cash payments having a present value equal to the creditors’ allowed secured claim within a reasonable time after confirmation (for example, from a proposed sale of assets contemplated in the plan).

The Absolute Priority Rule

Taking into account the priorities of claims, as set forth above, under the Absolute Priority Rule, if a class is impaired and votes against confirmation of a proposed plan, then the class must either (i) be paid in full (including unpaid accrued interest), or (ii) if paid less than in full, then no junior class of claims or interests may receive anything of value under the plan.

In cases where “old equity” wishes to retain an interest in the reorganized debtor, the Absolute Priority Rule can pose significant challenges. Old equity holders may argue that a “new value exception” to the Absolute Priority Rule applies and must establish the following at confirmation:

(i) they are making a new contribution in money or money’s worth;

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(ii) the contribution is reasonably equivalent to the value of the interest retained in the reorganized debtor; and

(iii) the new value contribution is necessary for implementation of a feasible plan of reorganization.\textsuperscript{124}

**The Effect of Plan Confirmation**

Once the plan is confirmed, the debtor’s assets and liabilities are subject to the terms of the plan and all creditors and parties in interest are bound to the terms of the plan, whether or not they voted for the plan.\textsuperscript{125} Typically, the bankruptcy court retains jurisdiction to enforce the terms of the plan and resolve any disputes arising from the plan or that impact distributions to be made under the plan.

If a plan is not confirmed, the debtor and/or other parties in interest may seek to propose an alternative plan as the debtor’s exclusive period to propose a plan will likely have lapsed by this point.\textsuperscript{126} Parties may also seek to convert the case to a liquidation if there is no reasonable prospect of reorganization.\textsuperscript{127}

**IV. Some Basic Creditor Remedies And Strategies**

**Setoff**

Setoff rights that exist under state law as of the petition date are fully preserved in bankruptcy. Generally, setoff requires mutuality between the obligor and the obligee even though there may be multiple transactions or agreements arising at different times between the same parties.\textsuperscript{128}

The Bankruptcy Code permits the setoff of such mutual obligations so long as: (i) the offsetting obligations arise either entirely prepetition or entirely postpetition; and (ii) the creditor is the holder of an allowed claim that was not acquired postpetition or within the 90-day preference period while the debtor was insolvent (except for certain securities and derivative contracts that are protected by certain safe harbor provisions).\textsuperscript{129} However, the exercise of setoff rights is subject to the automatic stay.\textsuperscript{130} Therefore, creditors should generally obtain relief from the automatic stay before exercising setoff rights to avoid the risk of a stay violation.

In the meantime, should the debtor attempt to seize an asset (like a bank account) the bank or creditor holding the funds may assert that the account is subject to an “administrative hold” pending the court’s determination of their setoff rights (and promptly file a motion seeking relief from stay to exercise setoff rights).\textsuperscript{131} Further, a creditor with a setoff right may assert it is

\textsuperscript{124} See 

\textsuperscript{125} 11 U.S.C. § 1141.

\textsuperscript{126} 11 U.S.C. § 1121(c).

\textsuperscript{127} 11 U.S.C. § 1121(b).

\textsuperscript{128} See Meyer Med. Physicians Group, Ltd. v. Health Care Serv. Corp., 385 F.3d 1039 (7th Cir. 2004).

\textsuperscript{129} 11 U.S.C. § 553(a); In re Davidovich, 901 F.2d 1533, 1537 (10th Cir. 1990).

\textsuperscript{130} 11 U.S.C. § 362(a)(7).

a secured creditor to the extent of the setoff and that turnover of funds against which it has a setoff right cannot be compelled by the debtor.\textsuperscript{132}

A creditor that exercises its setoff rights within the 90-day preference period faces the risk of a preferential transfer to the extent there has been an “improvement in position” as the result of the setoff while the debtor was insolvent.\textsuperscript{133} Nevertheless, a creditor’s best strategy may be to notify the debtor it has exercised its setoff rights if an imminent bankruptcy filing is suspected in order to avoid being subject to the automatic stay, particularly if any preference exposure is nominal.

If the setoff involves a postpetition debt against a postpetition asset, courts have allowed the exercise of setoff.\textsuperscript{134} Yet, it would be most prudent for a creditor to first seek relief from the automatic stay to avoid litigation over alleged stay violations or unauthorized postpetition transactions.

\textit{Recoupment}

The right to recoupment arises when some type of overpayment has been made and the creditor’s claim and the amount owed to the debtor arise from a single contract or transaction, unlike setoff claims which arise out of different transactions.\textsuperscript{135} As discussed above, the Bankruptcy Code does not allow the setoff of prepetition claims against postpetition assets; however, a creditor may assert the right to recoup a prepetition overpayment against a postpetition obligation.\textsuperscript{136} Courts generally hold that the right of recoupment is not subject to the automatic stay because it is in the nature of a creditors’ defense to a claim asserted by the debtor.\textsuperscript{137} Not surprisingly, the issue of whether a single transaction or multiple transactions are involved can be the subject of litigation, and therefore can implicate alleged violations of the automatic stay if the debtor alleges multiple transactions are at issue in order to restrict the creditors’ ability to assert its recoupment remedy. Therefore, if multiple transactions are potentially at issue, a creditor may be best served by seeking relief from the stay to assert its rights as a precaution.

\textit{Reclamation}

Even though the automatic stay prohibits the repossession of goods in general, a creditor may assert the right to reclaim goods delivered to a debtor within forty-five (45) days prior to the petition date while the debtor was insolvent.\textsuperscript{138} This right is premised upon the creditor’s right to similar relief outside of bankruptcy under section 2-702(2) of the UCC to demand the return of goods shipped on credit upon discovery that the buyer is insolvent (provided demand is made within ten (10) days after the buyer’s receipt of the goods).

\textsuperscript{132} 11 U.S.C. § 506(a); In re Treco, 240 F.3d 148 (2d Cir. 2001).
\textsuperscript{133} 11 U.S.C. § 553(b).
\textsuperscript{134} See e.g., Meyer Med., 385 F.3d 1039.
\textsuperscript{135} Matter of Kosadnar, 157 F.3d 1011 (5th Cir. 1998); In re HQ Global Holdings, Inc., 290 B.R. 78 (Bankr. D. Del 2003).
\textsuperscript{136} See In re TLC Hosp., Inc., 224 F.3d 1008 (9th Cir. 2000); In re Anes, 195 F.3d 177 (3rd Cir. 1999).
\textsuperscript{137} Lee v. Schweiker, 739 F.2d 870 (3d Cir. 1984).
\textsuperscript{138} 11 U.S.C. § 546(c).
The Bankruptcy Code allows for an expanded 45-day look-back period, provided the reclamation demand is delivered by the 45th day after the debtor’s receipt of the goods or, if such time period expires after the petition date, then by no later than the 20th day after the petition date. If a timely reclamation notice is sent, and ignored by the debtor, the creditor should file a motion to enforce its reclamation rights for the 45-day period. Failure to assert reclamation rights could provide grounds for the debtor to argue those rights have been waived.

However, the creditor’s reclamation rights are subject to the rights of a holder of a perfected security interest in such goods and the proceeds thereof. As a practical matter, this may render the reclamation right worthless where there is an undersecured lender with a perfected security interest in all inventory of the debtor. Also, where the value of inventory is uncertain as against the secured claims asserted against the inventory, it may not be worth it for the creditor to commence protracted and expensive reclamation litigation.

Even if no reclamation notice is filed, the creditor is entitled to an administrative claim for goods delivered within twenty (20) days prior to the petition date. Consequently, if a creditor’s reclamation claim is not much greater than its “twenty-day claim” it may not make sense, as a practical matter, to assert the reclamation claim since most creditors would prefer to be paid in full than reclaim the goods.

**Doing Business With the Debtor-Vendor Issues**

A vendor that does business with the debtor during the chapter 11 case is entitled to administrative claim status if the debtor induces postpetition performance and the vendor has provided a benefit to the debtor’s estate. Although this is not a guarantee of payment, administrative claims are typically paid in full unless there is an administrative insolvency, as discussed above. As a practical matter, however, it may be difficult to assess the risk of an administrative insolvency early in the case. On the other hand, the vendor may have an opportunity to increase its share of orders from the debtor if other vendors are reluctant to extend credit or have restricted the debtor to C.O.D. terms. A careful analysis of available financial information from the debtor’s schedules and public filings should be undertaken in order to assess postpetition credit risk taking into account the likelihood of liquidation versus reorganization and the extent of secured liens on the company’s assets.

A vendor that has a purchase order or open account relationship, and no contract obligation to supply, is not required to extend postpetition credit to a debtor. However, the creditor should not condition delivery of goods upon payment of its prepetition claim – that would be a violation of the automatic stay. Nevertheless, this type of vendor may cease to ship goods, ship only on a C.O.D. basis, or negotiate new (shorter) credit terms for the shipment of goods postpetition. Conversely, if a supplier files for bankruptcy protection, a nondebtor customer contractually obligated to purchase goods must purchase and pay for the goods in accordance with the contract or risk a breach of contract claim by the debtor.

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140 See In re Jartran, Inc., 732 F.2d 584, 586-587 (7th Cir. 1984) (claimant must demonstrate that the debt (1) arose out of a transaction with the debtor-in-possession; and (2) benefitted the operation of the debtor's business) (citing In re Mammoth Mart, Inc., 536 F.2d 950, 954 (1st Cir. 1976)).
A vendor that is obligated to supply goods/services under an executory contract is in a more difficult position than a vendor with a purchase order relationship. It is widely accepted that an executory contract remains in effect pending assumption or rejection by a debtor, and that during this time frame, the contract is not enforceable against the debtor even though the debtor may seek to enforce the contract pending its decision to assume or reject.\textsuperscript{141} As a corollary to this rule, it is well established that if the debtor continues to receive benefits under the executory contract it “is obligated to pay for the reasonable value of those services, . . . which, depending on the circumstances of a particular contract, may be what is specified in the contract.”\textsuperscript{142}

Some courts have recognized that prior to assumption, a vendor may suspend performance because neither section 362 nor any other section of the Bankruptcy Code prohibits a creditor from refusing to continue performance where the debtor is in breach of that agreement, and that the debtor is sufficiently protected by its right to assume the contract and cure outstanding defaults.\textsuperscript{143} Other courts disagree, however, and require the nondebtor vendor to perform pending the debtor’s decision to assume or reject.\textsuperscript{144} In cases where the debtor has sought an injunction to compel a vendor to perform, courts that have granted such relief conditioned upon the debtor paying for the postpetition goods/services provided by the creditor in accordance with the terms of the contract.\textsuperscript{145}

Typically, the debtor is not in a position to assume the contract and cure outstanding defaults early in the case. The debtor may assert that failure to ship is a material postpetition breach of the supply agreement entitling the debtor to assert a damage claim against the vendor. Although postpetition vendors are entitled to assert administrative claims for any goods/services provided postpetition, which in turn are entitled to be paid in full, they may not wish to risk an administrative insolvency. At a minimum, a vendor should file a motion to ensure it is paid the contract price for any goods/services provided postpetition.\textsuperscript{146} Vendors may also consider filing a motion to compel assumption or rejection of their contract or in the alternative seeking relief from the automatic stay (in an abundance of caution) to suspend performance unless the debtor pays in full for postpetition shipments on delivery as required under the contract.

\textsuperscript{141} Pub. Serv. Co. of N.H., 884 F.2d 11, 14 (1st Cir. 1989).
\textsuperscript{143} See e.g., In re Lucre, Inc., 339 B.R. 648, 652 (Bankr. W.D. Mich. 2006) (the right of one party to cease performing under an agreement if the other party is in material breach is fundamental to any contract where both parties have ongoing obligations).
\textsuperscript{144} See e.g., In re Pittsburgh-Canfield Corp., 283 B.R. 231, 238 (Bankr. N.D. Ohio 2002) (nondebtor party “cannot unilaterally elect to cease performance on executory contract prior to assumption or rejection”); In re Feyline Presents, Inc., 81 B.R. 623, 627 (Bankr. D. Colo. 1988) (creditor exposed to suit for damages after postpetition unilateral suspension without seeking relief from automatic stay).
\textsuperscript{145} See e.g., In re Continental Energy Assoc. Ltd. P’ship, 178 B.R. 405, 408 (debtor required to pay contract price in order to obtain injunction compelling vendor to provide fuel under supply contract pending assumption or rejection); Matter of Whitcomb & Keller Mortgage Co., Inc., 715 F.2d 375, 378-380 (7th Cir. 1983) (injunction appropriate to compel performance where payments made by debtor and nondebtor suffers no prejudice).
\textsuperscript{146} See e.g., In re Collins & Aikman Corp., 384 B.R. 751, 763 (Bankr. E.D. Mich. 2008) (debtor required to pay invoice price for inducing creditor to provide postpetition goods/services); In re Action Transit, Inc., 2008 Bankr. LEXIS 513 (Bankr. E.D. Wis. 2008) (until debtor rejects equipment lease, the debtor must abide by terms of the lease); In re Native Am. Sys., 368 B.R. 75, 80 (Bankr. D. Colo. 2006) (contract price found to be reasonable value of computer network services).
Many debtors obtain court authority to pay the prepetition claims of designated “critical vendors” in full. This status is usually reserved for vendors that the debtor (in its discretion) determines are essential to its postpetition business operations and are not otherwise obligated to supply goods. The current trend in most courts is for the debtor to obtain a blanket court order to designate and pay such claims, subject to a cap.\textsuperscript{147} This allows the debtor to conduct individual negotiations with vendors for payment of all or a portion of their prepetition claims in exchange for guaranteeing to extend postpetition credit to the debtor on the same terms in place prior to the petition date. Vendors are typically required to sign a “critical vendor agreement” which provides that failure to extend such credit during the chapter 11 case will give rise to the debtor’s right to recover the critical vendor payment.

Vendors should be aware that a debtor/trustee may not pursue preference payments made pursuant to a contract that has been assumed by the estate. Courts recognize that had the creditor not been paid prepetition, it would have had an increased cure claim that the debtor would have to pay upon assumption.\textsuperscript{148} Therefore, as a strategy, a creditor may wish to structure its pricing and terms relationship under a master supply agreement that must be assumed if the debtor wishes to retain those credit terms, thereby requiring a cure of prepetition amounts due and the elimination of all preference exposure.

**Proofs of Claim**

In addition to analyzing and preserving any available setoff, recoupment, reclamation and other rights as set forth above, a timely proof of claim should be filed asserting all legal and factual grounds for any claims against the debtor with the appropriate invoices, contract and supporting documentation attached. Failure to file a timely proof of claim after notice of the bankruptcy case typically results in disallowance of the claim, unless the creditor can establish excusable neglect.\textsuperscript{149}

It should be noted, that regardless of contractual provisions entitling an unsecured creditor to recover interest, interest ceases to accrue on the petition date and claims for postpetition interest are disallowed.\textsuperscript{150} However, if the debtor’s estate is solvent, unsecured creditors are entitled to recover interest before any payments are made to holders of junior classes or interests.\textsuperscript{151} Secured creditors, in contrast, are entitled to the recovery of interest as part of their allowed claim, as discussed above.

**Automatic Stay – Strategies**

Even though bankruptcy courts are reluctant to grant relief from the automatic stay early, a secured creditor should consider making an early request in order to trigger its right to adequate protection for future loss of collateral value, which some courts have held are not triggered until

\textsuperscript{147} Some courts have more strict requirements for evidence establishing the need to pay specific critical vendors. See e.g., Capital Factors, Inc. v. Kmart Corp. (In re Kmart Corp.), 359 F.3d 866 (7th Cir. 2004).


\textsuperscript{150} 11 U.S.C. § 502(b); In re Cajun Electric Power Co-op, Inc., 185 F.3d 446 (5th Cir. 1999).

\textsuperscript{151} 11 U.S.C. §§ 726(a)(5); 1129(a)(7); 1129(b)(2)(B).
the creditor files a motion for relief from stay (or in the alternative, adequate protection).\textsuperscript{152} A creditor may seek to take advantage of the ability to obtain a relatively quick hearing on account of provisions that provide the automatic stay will be deemed to terminate thirty (30) days after a request is made, unless the court orders the stay to continue in effect.\textsuperscript{153}

Another reason to move early is to create a record for the court as to the “cause” justifying relief from stay. Because “cause” can include a wide range of factors, such as undue delays by the debtor, misconduct or mismanagement, waste, and the lack of any reasonable prospects for reorganization, an early request that is denied may serve as a reference point to a later request, effectively focusing the court on the debtor’s lack of progress during the case.

Prepetition waivers of the automatic stay may seem appealing but they are rarely enforced. Such waivers are generally considered void as against public policy. However, a waiver that was given in the context of a meaningful prepetition restructuring, after the debtor was afforded a timeline to refinance or reorganize its affairs, can serve as an additional factor to help persuade the court to expedite the time frame for granting relief from stay.\textsuperscript{154}

\textit{Property of the Estate – Strategies}

In some circumstances, a creditor can minimize potential preference or fraudulent transfer litigation risk by structuring a transaction to defeat the “property of the estate” element required for such avoidance actions. Effective tools include establishing escrows, “earmarked loans,” letters of credit, and bailment arrangements, as discussed below. Creditors should also be aware when certain strategies are not effective to exclude property from the estate, and, at a minimum, ensure a UCC-1 financing statement is filed to perfect any resulting security interest in property of the estate, as discussed below.

With respect to escrow accounts, courts look to a number of factors to determine if the funds are property of the estate, including: whether the debtor initiated and/or agreed to the escrow; what, if any, control the debtor exercises over the funds; the nature of the funds deposited; the designated recipient of any residual; the purpose of the account; and the party that pays interest on the funds.\textsuperscript{155} Features of a successful escrow account strategy, in order to effectively deem the funds excluded from property of the estate, include: the debtor should not have legal title to the funds; the funds should be held by an independent third party; the debtor should have no access to or discretion on the use of the funds; the agreement should state the debtor has no ownership interest in the funds except for (if necessary) a contingent interest in any potential residual; and interest should be taxable to the creditor beneficiary with a credit due back on account of any interest paid on residual funds that are returned to the debtor.\textsuperscript{156}

\textsuperscript{153}11 U.S.C. § 362(e).
\textsuperscript{155}See e.g., In re Cedar Rapids Meats, Inc., 121 B.R. 562, 567 (Bankr. N.D. Iowa 1990) (quoting In re World Comm., Inc., 72 B.R. 498, 501 (C.D. Utah 1987)); In the Matter of Southmark Corp., 49 F.3d 1111 (5th Cir. 1995); In re Scanlon, 239 F.3d 1195 (11th Cir. 2001).
\textsuperscript{156}See e.g., In re AGSY, Inc., 120 B.R. 313, 319 (Bankr. S.D.N.Y. 1990); In re Atlantic Gulf Communities Corp., 369 B.R. 156, 164 (Bankr. D. Del. 2007); In re Weatherite, 46 F.3d 1149 (9th Cir. 1995).
Thus, a “debt reserve account” established as an escrow account can be deemed to “not be property of the estate” except for the debtor’s contingent interest in residual funds in the account, subject to the terms of the escrow/debt reserve agreement.\(^157\) Such accounts are typically funded from a new loan at the outset and deposited with a collateral agent or trustee that has sole discretion and control over the use of the account for making debt service payments over the life of the loan.

In contrast, deposit account control agreements are viewed as being property of the estate subject to a security interest in favor of the creditor. For business reasons, for example, where the debtor is reluctant to agree that the creditor may retain interest income in an escrow account, the parties can agree to instead establish a deposit control agreement which effectuates perfection of an interest in a bank deposit account by providing a mechanism for the creditor to obtain “control” of the account as defined in the UCC.\(^158\) Typically, the creditor enters into a form “control agreement” with the bank and debtor allowing the bank to follow the creditor’s instructions upon default regarding disposition of the funds without the debtor’s consent. Any interest income on the deposit account would typically be taxable to the debtor pre-default and to the creditor post-default.

Another strategy, if a new loan is part of the transaction, is to exclude loan proceeds from property of the estate under the “earmarking doctrine.” This doctrine applies if: (i) there is an agreement between a new lender and the debtor that the new funds will be used to pay a specified antecedent debt; (ii) the agreement is performed in accordance with its terms; and (iii) the estate is not diminished, even if the debtor requests the new loan and obtains the funds in order to pay the creditor directly.\(^159\)

A letter of credit is another mechanism to exclude property from the estate and protect a creditor from preference and automatic stay exposure. Courts uniformly hold that a letter of credit is an independent obligation of the issuing bank and that therefore, under the “independence principle,” the proceeds of a letter of credit are not property of the estate and are not subject to the automatic stay.\(^160\) In cases where the debtor has posted a letter of credit as security and the letter of credit proceeds exceed the secured claim, however, the excess proceeds may be property of the estate and the letter of credit may be treated as a security deposit.\(^161\)

A potential pitfall for vendors on property of the estate issues arises from the use of agreements that provide for the sale of goods and purported retention of title by the seller until the buyer has paid for the goods. It would be a mistake to rely upon such a provision to exclude property from a debtor’s estate because under the UCC, even if an agreement provides for title to remain with the seller, upon delivery of the goods to the buyer, title to the goods is deemed to pass to the buyer.\(^162\) In effect, the contract is disregarded as to title and instead is deemed to be a

\(^{157}\) See In re Neuton, 922 F.2d 1379, 1382-1383 (9th Cir. 1990); (contingent interests are property of the estate).

\(^{158}\) U.C.C. §§ 9-312(b)(1), 9-314(b); 9-104(a); 9-102(29).

\(^{159}\) See e.g., In re Adams, 240 B.R. 807 (Bankr. D. Me. 1999); In re Superior Stamp & Coin Co., 223 F.3d 1004 (9th Cir. 2000).


\(^{161}\) See e.g., Redback Networks, Inc. v. Mayan Networks Corporation (In re Mayan Networks Corporation), 42 B.C.D. 196 (9th Cir. BAP 2004).

\(^{162}\) U.C.C. §§ 2-401, 1-201(35).
security agreement under which the seller retains a security interest in the goods. Therefore, in a bankruptcy case, the debtor/trustee would be the owner of the goods and the seller would, at best, be the holder of an unperfected security interest if no UCC-1 financing statement was filed.

Pitfalls also abound in the arena of bailments and consignments which can be confused with each other and are subject to entirely different rules. A bailment occurs when property is entrusted to a party temporarily for some purpose and, upon the fulfillment of that purpose, the same property is: (i) “redelivered to the person who originally delivered it; (ii) dealt with according to the bailor’s directions; or (iii) kept until the bailor reclaims the goods.” A bailment therefore generally involves a debtor holding the same property of the bailor under an arrangement subject to the bailor’s further instructions, and as such is not property of the debtor’s estate and not subject to the automatic stay.

Sales on consignment fall into two distinct categories: (i) “a sale on approval” under which goods sold are subject to the debtor’s testing and acceptance; and (ii) “a sale or return,” where goods are delivered to a merchant debtor for re-sale to third parties. In the “sale on approval” situation, the goods remain property of the seller and therefore are not property of a debtor’s estate until the debtor accepts the goods. In the “sale or return” situation, the goods are property of the estate and subject to claims of the debtor’s creditors while in the debtor’s possession. However, both types of consignments are deemed by operation of law to be security interests for purposes of determining the rights of third parties. Therefore, a creditor’s failure to file a UCC-1 financing statement will typically result in its claim being treated as an unsecured claim by the debtor/trustee in the shoes of a hypothetical lien creditor (as discussed above) while the subject goods are treated as property of the estate.

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163 See Stieff v. City of San Antonio, 111 S.W.2d 1086 (Texas 1938).
164 Glenshaw Glass Company, 67 F.3d 470, 477 (3rd Cir. 1995).
165 U.C.C. § 2-326(2).
166 U.C.C. § 9-319(a).