

**Austin Bar Association Construction Law Section
September 21, 2006 CLE Luncheon –
Bankruptcy Basics for the Non-Bankruptcy Lawyer,
and How to Avoid Common Traps**

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I. Recent Changes to United States Bankruptcy Code

In June, 1998, the United States House of Representatives passed what almost became the most sweeping bankruptcy reform legislation in twenty years. A parallel but slightly less stringent bill was passed by the Senate in September of 1998. The Senate and House versions were then reconciled just before Congress adjourned in October of 1998. The House approved the reconciled legislation but the Senate never voted on the final bill and it died on the Senate floor. Similar legislation was introduced in 1999. That legislation failed to pass in the fall session of Congress.

Similar reform legislation was passed by Congress at the close of the 2000 session but President Clinton vetoed the bankruptcy reform legislation on December 19, 2000, too late for Congress to override his veto, saying that it was unfair to ordinary debtors and working families who fall on hard times.

Similar legislation was again introduced in 2001. A conference committee meeting was scheduled for September 12, 2001, but never took place due to the events of 9/11. The House and Senate Bills were finally reconciled in 2002, but stalled after House-Senate conferees added language to bar the discharge of debts arising from abortion clinic protests

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, was passed by the United States Senate on March 10, 2005 and the United States House of Representatives on April 14, 2005, provides the most substantial revision to the Bankruptcy Code since its inception. The passage, for now, completes congressional efforts to change the Bankruptcy Code. The vote margin was less than in prior years, owing to heightened concerns raised by the bill's critics over the past several months. All 229 House Republicans who voted supported the bill. They were joined by 73 Democrats; 125 Democrats opposed the bill.

While most provisions apply to new cases filed 180 days after the date of enactment, there are important exceptions to this general rule. For example, several provisions relating to the homestead exemption are effective on the date of enactment. A provision concerning the courts' exclusive jurisdiction over matters relating to professionals employed in bankruptcy cases applies to new cases filed after the date of enactment. The provision increasing the wage priority to \$ 10,000 and expanding the look-back for such priorities from 90 to 180 days, is effective on the date of enactment, but applies only to cases filed on or after that date. A similar effective date applies to the expansion of the look-back period for fraudulent transfers for the benefit of insiders under employment contracts not in the ordinary course of business. The same is true of a provision requiring reinstatement of retiree benefit plans under certain circumstances and a provision requiring the United States Trustee to move for appointment of a trustee in chapter 11 cases where there are reasonable grounds to suspect fraud, dishonesty or criminal conduct on the part of certain corporate officials.

The revisions mandate pre-filing credit and budget counseling for consumers seeking bankruptcy protection under both chapters 7 and 13. In addition, the revisions require a "means test" for debtors to be eligible for a discharge under chapter 7. Section 707(b) of the

Bankruptcy Code has been amended to provide for dismissal of Chapter 7 cases or (with the debtor's consent) conversion to Chapter 13, upon a finding of abuse. Abuse is presumed if the debtor's current monthly income, excluding allowed deductions for expenses, permit the debtor to pay not less than (a) 25% of non-priority unsecured debt over 60 months or \$10,000.00. Expenses will be calculated as specified under the national standards and local standards issued by the IRS for the area where the Debtor resides as well as the Debtor's actual expenses. Debtors whose family income exceeds a national median for their size family would have to go through this "means testing" on the request of any creditor. Debtors with the ability to pay 25% or more of their unsecured debt would have to file a Plan under Chapter 13 and make payments for a minimum of 5 years. For individuals with higher than normal expenses (many of which would not be counted in the means testing), the new legislation may severely hamper or altogether eliminate their ability to file for bankruptcy protection. If the Debtor's income is less than the state median only the judge or Trustee may bring an abuse motion. A disabled veteran whose debts were incurred primarily during active duty is exempt from means testing.

The Homestead Exemption is limited to \$125,000.00 if the Debtor has owned the home for less than 1215 days (3.3 years). Any equity in a homestead which is the result of a fraudulent transfer is not exempt for ten years from the date of transfer. In addition, chapter 13 would be changed by requiring a minimum plan term of 5 years for debtors whose income exceeds the national median. Otherwise a three year minimum is required.

While the revisions primarily deal with various aspects of consumer bankruptcy cases, they also make changes that are applicable to business bankruptcy cases. For example, preference lawsuits will be curbed somewhat by a new requirement that the aggregate value of transfers be in excess of \$5,000 to be avoidable. A preference lawsuit may have to be brought in the United States District Court where the defendant resides if the allegedly avoidable transfers aggregate less than \$10,000. In addition, the ordinary course of business defense also has been strengthened for creditor/defendants. Meanwhile, the fraudulent transfer "look back" period has been generally extended from 1 to now 2 years prior to the bankruptcy filing, and to 10 years prior to the bankruptcy filing for a transfer by the debtor into a self-settled trust made with actual fraudulent intent.

Although the bill is designed to reduce bankruptcy filings and increase payments to creditors in bankruptcy, the bill contains a number of provisions that may impair the overall effectiveness of the consumer credit system. The longer minimum plan length in Chapter 13 may increase the number of plans that default or fail. The legislation may also lead to greater court involvement and may generate additional expense for the courts and creditors. Of course, the extent to which the changes will achieve the desired goals or create undesirable results cannot be fully known until after the new system is in place.

II. Overview of Bankruptcy Law

Bankruptcy law in the United States is a creature of federal law, specifically, the Bankruptcy Code, found in title 11 of the United States Code. The United States Constitution itself mandates the implementation of "uniform laws on the subject of

bankruptcy” in Article I, section 8. Prior to the enactment of bankruptcy laws, particularly in England, persons who were unable to pay their debts were sometimes sent to prison – certainly a harsh result, and hardly helpful to the debtor or his creditors. The purpose of the bankruptcy law as enacted in the United States is to address, in a comprehensive way, the resolution of corporate and individual insolvency. The primary goals of bankruptcy laws are to (1) maximize the value of the estate and (2) distribute that value equally (pro rata) to similarly situated creditors. Without such laws, creditors would be economically motivated to grab as much value as possible for themselves leaving less for creditors as a group and jeopardizing what remains of the debtor’s going concern value. All bankruptcy concepts flow from these primary goals, and understanding these primary goals is the key to understanding the bankruptcy process.

A. Bankruptcy Code and Rules

The codification of bankruptcy law in the United States is found at 11 U.S.C. §§ 101, *et seq.* This title of the United States Code is most commonly referred to as the “Bankruptcy Code.” Individual states also have insolvency-type remedies such as assignments for the benefit of creditors, receiverships, and similar laws that can be used instead of federal bankruptcy law. One advantage to the federal laws is that they, like Delaware corporate law, are well developed in both codification and interpretive case law resulting in less uncertainty and more uniformity in their application.

The Bankruptcy Code, like other parts of the United States Code, are enacted by Congress. The Bankruptcy Rules, on the other hand, are promulgated by the United States Supreme Court and are secondary to the Code. However, the Bankruptcy Rules contain various deadlines and procedural rules that can curtail rights and remedies otherwise available under the Code.

Bankruptcy cases are filed in federal court which have exclusive jurisdiction over the bankruptcy cases themselves, although not necessarily over other litigation involving the debtor. These cases are typically referred automatically to specialized bankruptcy courts which hear only bankruptcy cases and related litigation.

B. Types of Bankruptcy Cases

The Bankruptcy Code is divided into 8 chapters. Chapters 1, 3, and 5 contain provisions that are generally applicable to all cases. Chapters 7 (liquidation), 9 (municipalities), 11 (reorganization), 12 (family farmer) and 13 (wage earner) refer to “types” of bankruptcy cases and each have a separate chapter to govern these “types.” The two main types that affect business creditors are:

1. Chapter 7: A corporation, partnership or other business entity as well as an individual can file for a chapter 7 bankruptcy. A chapter 7 bankruptcy is a liquidation of all assets that are not otherwise protected by personal exemptions (only individuals have exemptions). A chapter 7 trustee is appointed upon the filing of the chapter 7 case, selected from a panel of individuals designated to serve in that capacity in that district. In a chapter 7,

the trustee takes possession of all of the property of the debtor, sells it and then distributes the proceeds of the sale to creditors who have filed a claim

2. Chapter 11: Both individuals and business entities can file a chapter 11. A chapter 11 is usually a “reorganization” of the entity, but it can also be used to liquidate an entity, usually when the liquidation involves a sale of an operating company or its assets. One primary distinction between and chapter 7 and a chapter 11 is that a chapter 11 debtor steps into the shoes of a trustee and continues to manage the business and the implementation of the reorganization. For cause, however, the bankruptcy court may appoint a chapter 11 trustee to manage the debtor’s business. The other primary distinction is that the chapter 11 process involves the filing of a “plan of reorganization” that sets out the means by which the debtor intends to reorganize its business (or sell it) and distribute the proceeds.

III. Immediate Steps to Take When a Bankruptcy is Filed

A. Obtaining Information About the Case

Determining what to do about a bankruptcy filing requires information about what kind of case it is and where it is pending. The issue for most creditors is that they do not find out soon enough that a case has been filed, and even if they have received notice, it was sent to someone within the organization that does not forward it to the appropriate person. As discussed below, finding out about a case early can help to prevent actions being taken by the debtor that are ultimately adverse to the creditors’ interests.

1. PACER: A few debtors will actually say they are in bankruptcy when they are not. The best response to the statement “we filed bankruptcy” is to ask for the case number and the place of filing. If you do not have that information, there is an electronic case information system on the Internet called “PACER” at <http://www.pacer.uscourts.gov>. From that website, you can access both a national database and each district’s electronic docketing system by using the individual links provided on that page, although an account is required to pay nominal access charges. In the national database, you can search the “US Party Case Index” that will look for that company’s name in all of the bankruptcy courts in the nation, with a few exceptions. A negative search on the US Party Case Index usually means that there has been no filing (cases are immediately docketed upon filing in most districts).

2. The Voluntary Petition: Once you locate the case on PACER, most courts allow you to download the filings in a .pdf format. This information is also available by physically going to the court, although this is becoming more rare. A case is initiated by filing a voluntary petition. The required contents of a petition are (1) a voluntary petition signed by an authorized officer of the company; (2) a brief description of the assets and liabilities of the corporation; (3) (usually by local rule) a document that evidences the corporation’s authority to file (*i.e.*, a Certificate of Resolution); (4) only in a chapter 11 case, a listing of the 20 largest unsecured creditors (from which the Committee of Unsecured Creditors will be selected); and (5) a “matrix” of all creditors with current mailing addresses.

3. The Statements and Schedules: “Statements and Schedules” refer to two documents, one is the Statement of Financial Affairs (or SOFA) and the other is the Schedules of Assets and Liabilities (or “Schedules”). The Statements and Schedules are usually filed within 15 days of the commencement of the bankruptcy case. The Statement of Financial Affairs is a series of questions that detail the debtor’s transactions and relationships that may explain how they ended up in bankruptcy and what potential litigation issues may be. The Schedules list the debtor’s assets and executory contracts, as well as the debtor’s liabilities broken down in to secured, priority and unsecured claims. Although the Statements and Schedules are very important, they are not always available by PACER if they are voluminous (as is the case with most business filings). The debtor should, however, provide copies to creditors upon request. If an insurance agreement is not listed on the Debtor’s schedules, consideration of a motion to require identification as well as assumption or rejection should be made.

4. The 341 Notice: Within about two weeks of the filing, the court will send out a “Notice of Commencement of Case and of Meeting of Creditors” to all of the creditors listed on the matrix. A sample of this notice is attached as Exhibit “A.” This notice will provide (1) the case number and place of filing; (2) a proof of claim form (3) the date, place and time for the 341(a) meeting of creditors (4) the identity of the debtor’s attorney and (5) the deadlines for filing claims and (for individuals) for objecting to discharge. Often, this is the first notice that a creditor receives of the filing, so recognizing it is extremely important. Usually, the debtor will list an address on the matrix that is the same as where the debtor sends its payments. If the creditor has payments sent to a lock box, this usually means that notice of the bankruptcy case will be delayed or missed altogether. Unless the creditor can show that the debtor was intentionally misleading in its listing of the creditor, the creditor’s internal “mail” issues will not excuse missing these important deadlines.

5. The Creditors’ Meeting: The “first meeting of creditors” is usually held approximately 4-5 weeks after the filing of the case. In a chapter 11, the United States Trustee (a branch of the Justice Department created to oversee the bankruptcy proceedings) will conduct the creditors’ meeting. In a chapter 7 case, the chapter 7 panel trustee appointed in that case will conduct the meeting. In both instances, the debtor is required to appear to answer the creditors’ questions under oath. Before attending the creditors’ meeting, it helps to first review the statements and schedules. Any questions not answered there can be directed to the debtor or the debtor’s counsel, who are both required to provide information to creditors under the Bankruptcy Code. Then compare the schedules to prior financial information to see if there are missing assets or still unanswered questions. If the creditor has questions about particular issues that have not been answered by the debtor or its counsel, the creditors meeting is a good place to get that information. The 341 meeting may also be used to get early discovery for a potential cause of action or a defense to a cause of action.

6. Rule 2004 Examination: If a debtor is particularly uncooperative, the creditors can take a “Rule 2004 Examination” which is essentially a deposition without an underlying lawsuit. A 2004 exam is also available as against any entity possessing information about the assets of the estate.

7. Notice of Appearance: Filing a “notice of appearance” is a good way to insure that all pleadings filed in the case are mailed to you. See Exhibit “B.” Note that a Notice of Appearance will usually result in a large volume of mail and should probably be reserved for cases in which the creditor’s interest is particularly large.

B. The Automatic Stay

The automatic stay is an essential tool for achieving the Bankruptcy Code’s primary goal of equal distribution to creditors. The stay acts to keep one aggressive creditor from dissipating the pool of assets available for all creditors. In basic terms, the automatic stay means (1) do not try to collect your debt after the bankruptcy cases is filed and (2) do not try to take or otherwise impair property in which the debtor has an interest to satisfy your claim. The stay is automatic, but it can also be modified by motion to the court in a variety of scenarios.

1. Communications with the Debtor: In generally, the automatic stay does not prohibit communications between the debtor and the creditor. In the case of an ongoing supply contract, for example, the creditor and debtor must continue to communicate for the business relationship itself. What is prohibited are attempts to collect a debt, and even some inadvertent communications can violate the stay such as automatic billings and actions by debt collectors. Creditors can and should ask questions about the case and about the debtor’s business.

2. Actions Prohibited by the Stay: Some obvious examples of stay violations are sending repeated demand letters for payment of a prepetition debt, calling to collect a prepetition debt, or initiating foreclosure actions on account of a prepetition debt. Less obvious stay violations are setting off a claim against the debtor with one that the creditor owes the debtor, particularly under separate contracts. (Offsetting claims arising under the same contract may be “recoupment,” which is not stayed).

In the rare case where notice of the bankruptcy case was not provided, occasionally, agreements are terminated innocently, without notice. In such case, an annulment of the stay might be possible depending on the equities.

3. Actions Not Prohibited by the Stay: As stated above, there is no affirmative duty on the part of the creditor to continue to do business with the debtor in the absence of a long term contract that requires it. Although a “setoff” would violate the stay, merely preserving the right of setoff by not paying a debt owed to the estate may not be considered a stay violation. Calling a letter of credit does not violate the stay for the reason that the letter of credit is a contract between the beneficiary and the issuing bank and does not constitute property of the debtor’s estate. Collecting against a non-bankrupt guarantor does not violate the stay for the same reason.

Actions that are ministerial or regulatory in nature are not stayed. A governmental authority can continue to enforce those regulations against a bankrupt debtor except in those circumstances when the government action looks more like debt collection. For example, an

EPA enforcement order can continue to be enforced to prevent additional pollution notwithstanding the bankruptcy stay, but an order establishing a penalty for pre-petition violations probably is stayed.

Because of the stay, and because of the nature of bankruptcy law treating claims as they were on the Petition Date, if a mechanic's lien is not perfected before the bankruptcy is filed, a contractor, subcontractor or supplier may be relegated to the status of an unsecured creditor. Liens can be perfected after the bankruptcy filing under certain circumstances without violating the automatic stay. *See, e.g., In re Nash Phillips/Copus, Inc.*, 78 B.R. 798 (Bankr. D. Tex. 1987).

While a mechanic's lien claimant may be able to perfect its lien post-petition, enforcement or foreclosure is not permissible and any attempts to enforce the lien would violate the stay. *Id.* The automatic stay creates problems because state law usually requires claimants to foreclose within a short period of time. However, 11 U.S.C. § 108 provides for tolling of applicable statutes of limitation, and a secured proof of claim may also be filed.

4. Litigation: Generally, litigation pending between a plaintiff and a debtor defendant at the time of the bankruptcy is stayed. However, depending upon the circumstances, a creditor may seek relief to allow the litigation to proceed to judgment. Collection of the judgment would be stayed, but the creditor may be able to liquidate its claim in the original forum. Care must be taken to balance preserving rights against the debtor via a proof of claim and submitting to the jurisdiction of the bankruptcy court for adjudication. Because an appeal is a continuation of judicial action, it is automatically stayed if it is against the debtor. If the debtor was the plaintiff in the court below, the stay does not apply; if the debtor was the defendant, any further action is stayed.

The Texas Rules of Appellate Procedure modify this general rule. Rule 8.1 of the Texas Rules of Appellate Procedure provides that any party may file a notice that a party is in bankruptcy. 8.2 of the Texas Rules of Appellate Procedure provides that a bankruptcy suspends the appeal and all periods in these rules from the date when the bankruptcy petition is filed until the appellate court reinstates or severs the appeal in accordance with federal law. A period that began to run and had not expired at the time the proceeding was suspended begins anew when the proceeding is reinstated or severed under 8.3. A document filed by a party while the proceeding is suspended will be deemed filed on the same day, but after, the court reinstates or severs the appeal and will not be considered ineffective because it was filed while the proceeding was suspended.

Thus, care must always be taken when an appeal is pending and a party files for protection under the Bankruptcy Code.

When a corporate entity files bankruptcy, as a general rule, the stay will not prevent litigation from proceeding against the individual officers and directors of the entity. Thus, for example, fraud claims against officers and directors may proceed or be commenced despite the pendency of the case.

When the individual officers and directors of an insured file a case, careful consideration should be made regarding a timely objection to discharge. The Bankruptcy Code allows creditors to object to the discharge of those individuals engaging in certain types of fraud. The deadline to object to a discharge is generally fixed early in the case and care must be taken not to miss the opportunity when applicable.

C. Proofs of Claim

1. When to file: All creditors with actual or constructive notice of the bankruptcy case should file proofs of claim. A proof of claim is a statement of the amount owed to the creditor and the basis for that claim. An example of a proof of claim is attached as Exhibit "C." Proofs of claim should be filed by the proof of claim deadline, which is usually set by the court or by statute at or near 90 days after the first meeting of creditors, or 341 meeting, as described above.

2. "No Asset" Cases: Some chapter 7 cases are filed as "no asset" cases meaning that, in the debtor's estimation, no non-exempt assets will be left to pay any unsecured creditors. On the voluntary petition, there is a box that is checked to indicate whether the case is "asset" or "no asset." If the case is a "no asset" case, a claims bar date will not be set. This does not mean that creditors are prohibited from filing claims.

3. What box to check: Proofs of claim are "all purpose" forms that try to cover a wide range of possible creditors. Most claims that concern pre-petition events are going to be general unsecured claims. The boxes for the various priorities are a very narrow category of claims and do not apply to most creditors. Priority claims include taxes, employee wages, consumer customer deposits, alimony, and similar specialized claims. Secured claims are claims that are secured by a lien on property of the estate. If the debt is secured by a secured guaranty of a third party, it is not a secured claim against the debtor. **Claims for which the creditor can assert a right of setoff are secured claims. The "collateral" is the debt owed to the debtor and its value is the amount of that debt. It is extremely important for a creditor with a right of setoff to file its claim for the full amount of the amount owed by the debtor, even if the debtor owes the creditor more than that claim.** Failure to file a claim can result in loss of the right of setoff when the debtor later sues to recover the balance owed by the creditor. Certain claims which arise post-petition are entitled to priority. These so-called "administrative claims are paid before general unsecured claims. A claim for "administrative" priority is generally made by motion, not by filling out a proof of claim form. That said, many "administrative claims" are paid by the Debtor in the ordinary course of its business, and a motion may not be necessary.

IV. Conducting Business with a Debtor Operating in Chapter 11

In many ways, a chapter 11 debtor is a better credit risk than most companies. In a chapter 11, vendors that provide goods and services to a debtor post-petition are given the first priority in payment as compared to all other unsecured creditors, and the bankruptcy court is a quick forum to present and enforce claims for post-petition services. A prudent course of action may be to obtain court approval prior to conducting business with a debtor

on credit terms post-petition, particularly if the payment required is significant. The main exception to this maxim are cases in which there is a large secured creditor with a lien on virtually all of the assets and little in the way of positive cash flow. In such cases, there is a strong possibility of the debtor being “administratively insolvent,” that is unable to pay even post-petition debts in full. The good news is that administrative insolvency is more easily detected because of the increased availability of the debtor’s financial data in the form of the schedules (described above) and the requirement that the debtor file monthly operating reports. Monthly operating reports are essentially unaudited balance sheets and monthly cash flow statements. The key to continuing to do business with a chapter 11 debtor, therefore, is to access and monitor the information available to avoid non-payment.

A. Payment Terms

Under an existing long-term supply contract, unilaterally modifying payment terms would violate the automatic stay. In the absence of a contract, COD or other risk-free payment terms are certainly appropriate notwithstanding prior arrangements. Even under a long term contract, however, payment for goods or services actually delivered post-petition should be paid when due. In the absence of payment or if the debtor appears to be administratively insolvent, the supplier has the following options: (1) file a motion for adequate protection, *i.e.*, to modify the payment terms; (2) file a motion for relief from stay to terminate the contract; and/or (3) file a motion to compel assumption or rejection of the contract.

B. Necessity of Payment Doctrine

The “necessity of payment” doctrine was first developed as a theory by which chapter 11 debtors could pay employee wages post-petition that were actually earned pre-petition. In some jurisdictions, particularly Delaware, the doctrine has evolved to include payments to vendors (without long-term supply contracts) for pre-petition debts in exchange for those vendors continuing to supply goods to the chapter 11 debtor. The necessity of payment doctrine is a huge deviation from the equality of distribution concepts the underlie the Bankruptcy Code, and so is both narrowly applied by the courts that do apply it and rejected by most jurisdictions, including the 5th Circuit. Cases that have applied it do so when the debtor would cease profitable operations but for the continuation of certain supplier relationships. One example is an athletic shoe store that was required to pay pre-petition claims to athletic shoe manufacturers to get the current season’s styles into the stores. Still, the necessity of payment doctrine can be used in some jurisdictions. Rather than simply refusing to continue to supply the chapter 11 debtor, the necessity of payment doctrine demonstrates how continued cooperation may help a creditor “bootstrap” itself into getting better treatment than other creditors while getting the benefit of continued sales.

C. Executory Contract Issues

An “executory contract” is a contract that (1) has a certain duration or term, *i.e.*, is not yet fully performed (2) requires performance from both parties, *i.e.*, one supplies, one buys (3) has not yet expired by its own terms or as a result of a pre-petition termination event and (4) is not simply a loan or similar monetary obligation. Arguably, a simple purchase order is an executory contract until it is filled. Executory contracts are considered to be assets of the estate. If the debtor (or trustee) determines that an executory contract is burdensome, it can reject the contract. If the debtor wants to keep the contract after the bankruptcy case or assign it to a purchaser of the assets, for example, it can assume the contract and assign it to another entity subject to certain requirements of the Bankruptcy Code, but notwithstanding language in the contract prohibiting assignment.

1. Assumption Requirements: A debtor may assume a contract by meeting certain criteria. The most critical of these is that assumption must be accompanied by a “cure” of all existing defaults under the contract, usually the pre-petition arrearages. Assumption is often coupled with an assignment to a third party. Whether assumed or assumed and assigned, the debtor or the third party, as the case may be, must demonstrate that they can continue to perform under the contract. The term for this is “adequate assurance of future performance.” Adequate assurance does not require a guaranty of future performance. Rather, it requires a showing that the debtor or assignee of the contract is capable meeting the requirements of the contract and is likely to continue to do so in the future.

2. Consequences of Rejection: If the debtor determines that a contract is burdensome, it may reject the contract. Rejection does not terminate the contract however. It simply means that the debtor will no longer perform the contract and that the other party to the contract can file a claim for damages against the estate. Rejection would not, for example, terminate any obligations of a third party to the contract to continue to perform.

V. Protecting the Interests of Creditors in Chapter 11

A. First Day Issues

In almost every chapter 11 case, there are “first day pleadings” which typically consist of an employee wage motion (to pay pre-petition wages of employees), a cash collateral motion (to allow the debtor to use cash that may be subject to the secured creditors’ liens), a financing motion (to authorize the debtor to incur new secured financing), a motion to continue the debtor’s banking relationships, among others. These pleadings are usually filed on an emergency basis because these issues are fundamental to the continued operations of the debtor’s business. This also means that they are going to be heard prior to any creditors’ committee being appointed and prior to most creditors getting notice of the bankruptcy. However, the courts almost always require that these motions be faxed or sent overnight to the 20 largest unsecured creditors, although few of these creditors actually appear. There are certain provisions of the first day orders that can have long-term effects on the unsecured creditors. Some of the ones that creditors should look for and try to avert are (1) cross-

collateralization in cash collateral or financing orders; (2) cash collateral orders that eliminate or curtail the ability of creditors to avoid or contest the secured lenders' liens; (3) necessity of payment motions that act to prefer one unsecured creditor over another; (4) joint administration or cash management orders in multi-debtor cases that may have the effect of siphoning money away from one debtor and giving it to another without remedy to the affected creditors. In chapter 11 cases, the first day hearings will often include approval of an interim operating budget for the first fifteen days of the case. Subsequent budget approvals will then occur. All creditors claiming a lien on the assets of the Debtor should participate in the negotiation and approval of the budget.

B. Unsecured Creditors' Committee

The Unsecured Creditors' Committee is selected by the office of the United States Trustee from the list of the 20 largest unsecured creditors filed by the debtor. The U.S. Trustee sends a solicitation to some or part of the list and, based on those responses, appoints a committee. Once appointed, the committee will typically choose a chairman and hire counsel. The committee's counsel is paid from the assets of the estate. Depending on the size of the case, the committee may choose to not hire counsel because of the additional burden of paying yet another set of lawyers. In very large cases and some smaller ones, committees can get organized fairly quickly especially where the bankruptcy filing was not unexpected. In some cases, the committees take months to hire counsel, usually after the die has been cast as to many critical issues in the case. Committees can be enormously helpful, particularly in cases where the debtor's management needs corraling. Committees can also be an unnecessary burden, particularly in a liquidating chapter 11, where little value is added by their efforts. Some traits of an efficient and effective committee include:

1. Appointing a chairman with well-defined parameters and authority
2. Adopting and following bylaws for the conduct of committee business and defining the chairman's role
3. Regular telephonic and in-person meetings
4. Choosing battles that are meaningful and limiting unnecessary litigation
5. Streamlining the decision making process to eliminate delays, particularly in a fast moving case including use of e-mail and other group communications
6. Staying focused on the big picture, rather than minor skirmishes

VI. Preference Issues

A. Definition of a Preference

To understand what a preference is, it is helpful to understand why preferences are an essential part of the bankruptcy structure. To meet the Bankruptcy Code's goal of equality in distribution, *i.e.* that all similarly situated creditors should be treated equally, the Code reaches back into the pre-bankruptcy period to undo those situations in which one creditor got paid, or "preferred," to the detriment of others who did not. The Bankruptcy Code sets that reach back period at 90 days prepetition at which point, for this and other sections of the Code, the debtor is presumed to have been insolvent. The Bankruptcy Code, through the preference statute, attempts to equalize the treatment of all creditors based on what they would have received if the debtor had filed the bankruptcy and no aggressive creditor action had been taken. Thus, the essential elements of a preference are:

1. A transfer (including a payment, the attachment of a lien or other incident which impairs the debtor's rights in property);
2. Made within 90 days of the bankruptcy and while the debtor was insolvent;
3. On account of an antecedent debt (*i.e.* collecting a debt rather than a contemporaneous exchange);
4. That enabled the creditor to receive more than it would have received in a chapter 7 liquidation.

If there is an element of a preference that is not satisfied, then it is not a preference. Therefore, a payment on a claim more than 90 days prepetition is not a preference. An advance payment is not a preference because it is not on account of an antecedent, *i.e.*, pre-existing, debt. If the payment was made to an oversecured creditor, the payment is not a preference because that creditor would have received at least as much on account of its secured claim in a chapter 7.

B. Defenses to Preferences.

1. Ordinary Course The most common of the defenses to a preference claim is the ordinary course of business defense. This defense simply means that a payment made in the ordinary course of business of both the debtor and the creditor and made according to ordinary business terms is not recoverable as a preference. The case law that defines what ordinary course of business really means is somewhat complex. However, the standards of meeting the defense have been lessened somewhat by the 2005 changes. For most creditors, “ordinary course” means that the payments were made by check within normal terms. For example, if the contract calls for net 30 days, and the debtor has always paid within 30 days by check, payments received in the preference period that are paid by check within 30 days are probably not preferences. A payment by wire after 50 days when the contract and the payment history are 30 days is probably a preference. A payment after 60 days after repeated collection letters and phone calls is probably a preference. The cases tend to look at (1) the time of payment (2) the mode of payment and (3) the collection activities of the creditor to determine whether the payment was in the ordinary course.

2. Subsequent Unsecured New Value Recognizing that the creditor who gets paid but then continues to provide goods or services is not necessarily better off than one who never got paid, the Bankruptcy Code provides that a preference payment is not recoverable to the extent that the payee then provided new value (in the form of goods or services) that was both unpaid and unsecured at the time of the bankruptcy filing. Thus, if a supplier receives a payment of \$50,000, but then continues to provide goods with a value of \$20,000 that were both unpaid and unsecured at the time of filing, then only \$30,000 can be avoided as a preference.

3. Contemporaneous Exchange for New Value The obverse corollary to the “antecedent debt” element of a preference is the concept that any contemporaneous exchange is for new value is not a preference. Thus, if the payee is the corner deli and, in exchange for \$25, brings in the food for the board meeting, the transfer is a contemporaneous (at the same time) exchange for new value (the food). “New value” simply means that the exchange is not on account of an antecedent (old) debt. A common example of “value” that is not “new value” is a creditor’s agreement to forebear from collecting part of the old debt in exchange for the payment.

C. How to Minimize Preference Exposure while Maximizing Collections

1. Rather than insisting on payment for an old invoice before making a new shipment, treat the shipment as a COD. The payment on the COD shipment can then be characterized as a contemporaneous exchange for new value rather than a payment on the old debt.

2. Do not change the method or timing of payment if at all possible.

3. Avoid written collection efforts if possible. A phone call may be missed as evidence of collection in a cursory review for preferences later on.

4. Try to get payments on invoices that would be within terms rather than getting payments on the oldest invoices. If its August, and both June and July invoices are unpaid, try to get July paid rather than June. This may bring the payment within the ordinary course defense.

5. If all else fails, take the money. Preferences can be compromised through a variety of means, and some are not large enough to warrant litigation by the bankruptcy estate. Under a long-term contract that is later assumed, preference actions are necessarily abrogated as part of the requirement of curing defaults. Even if the payment is ultimately avoided, the creditor will have had the benefit of holding the money until it is ultimately returned, sometimes several years later.

VII. Conclusion

Bankruptcy is a collective process that attempts to maximize the returns to creditors while preserving the going concern or liquidation value of the business. Within this framework, there are numerous opportunities and pitfalls for creditors. While not exhaustive, this outline is intended to cover the kinds of issues that are likely to arise for a typical trade creditor. Each case has individualized issues that may require substantial refinement of these general concepts. Thus, specialized legal advice should be sought to address particular issues that may arise.