ULOTH, P.C.

ISSUES COMMONLY ARISING IN COMMERCIAL CONSTRUCTION BANKRUPTCIES

J. Douglas Uloth
Uloth, P.C.
www.uloth.net

Construction Law Section of the Dallas Bar Association
January 7, 2010

© James Douglas Uloth, 2010

Issues Commonly Arising in Commercial Construction Bankruptcies

Page

I. Introduction. 1
II. Changes in the Landscape Since the Last Wave of Real Estate Bankruptcies. 1
 A. External Changes in the Financial Environment. 1
 B. Internal Changes within the Bankruptcy Code. 2
 C. Changes in Caselaw. 3
  1. Expansion of Issue Preclusion and Claim Preclusion. 3
  2. Ability to Issue Money Judgment in Discharge Litigation 4
  3. Examiners 4
  4. Impact of decisions in *In re General Growth Properties, Inc.* 5
III. Basic Principles of Bankruptcy 5
 A. The Automatic Stay 5
 B. The Estate and the Debtor are not the Same. 7
 C. Property that Belongs to the Debtor Now Belongs to the Estate 7
 D. Property that Never Belonged to the Debtor Cannot Belong to the Estate 8
  1. Trust Fund and Earmarking-Benefits and Limitations 8
  2. Joint Check Agreements 9
 E. Types of Proceedings in Bankruptcy--Motion Practice (Contested Matters) or Trials (Adversary Proceedings) 10
 F. Discovery and Evidence in Bankruptcy 10
  1. Administrative Discovery 11
  2. Discovery Related to Proceedings 11
  3. The Rules of Evidence in Bankruptcy 11
 G. The Effect of Bankruptcy Code § 108(c) on Statutes of Limitations. 12
 H. Unscheduled Property 12
IV Involuntary Petitions 13
 A. Do You Really Want to File One? 13
 B. Effect of Filing and Operations of the Alleged Debtor in the Gap 14
 C. The Procedural Requirements 14
 D. Calculation of the Holders of a Claim 15
 E. Number of Petitioning Creditors Required 16
 F. Eligibility to Act as a Petitioning Creditor 17
 G. Proving the Debtor is Not General Paying its Debts 17
V. First Day Motions 18
VI. Early Opportunities to Gather Information 19
 A. An Early Look at Case Direction 19
 B. Cash Collateral Motions 20
  1. Scope of Cash Collateral 20
  2. Procedure 20
  3. Statutory Conditions for Use of Cash Collateral-Adequate Protection 21
 C. Debtor-in-Possession Financing 21
  1. Conditions for Authorization of Post Petition Financing 21
  2. Procedure 23
  3. New Developments 23

D. Carve-outs 23
E. The Schedules and Statements of Financial Affairs 24
VII. Critical Vendor Motions 24
VIII. Presenting a Claim 26
A. The Meaning of Claim 26
B. Time for Presenting a Claim 26
C. Procedure for Presenting a Claim 27
D. Priorities 28
E. The Informal Claim 29
F. Amendment of Claim After Filing 30
G. Recognition (Allowance) of the Claim and Claims Litigation 30
H. Estimation 31
I. Subordination and Recharacterization 31
IX. Reclamation and Administrative Claim for Goods Delivered prior to Bankruptcy 32
A. Creation of Federal Reclamation Right 32
B. Administrative Priority Claim For Goods Received Immediately Prior to Filing 32
X. Creditor Committees 33
A. Basis for Appointment 33
B. Duties of a Committee 33
C. Hiring Supporting Professionals 33
D. Decision to Seek or Accept Appointment 33
XI. Sales Free and Clear of Liens under § 363 34
A. Current Controversy over the Scope of Bankruptcy Code § 363 34
B. Procedure 34
C. Grounds for Approval of Use, Sale or Lease (but usually Sale) 35
1. Use of Non-bankruptcy law - Bankruptcy Code § 363(f)(1) 35
2. Sales Price Exceeds Aggregate Lien Value- Bankruptcy Code § 363(f)(3) 36
3. Interest is Subject to a Bona Fide Dispute - Bankruptcy Code § 363(f)(4) 36
4. Interest Holder Can be Compelled to Accept a Money for Interest - Bankruptcy Code § 363(f)(5) 36
D. Concerns to Contractors and Supplies in Connection with § 363 sales 37
E. Adequate Protection on an Interest Affected by a Sale 37
XII. Executory Contracts 37
A. Determination of Status of a Contract as an Executory Contract 37
1. Defining an Executory Contract 37
2. Effect of Termination Prior to Case Filing and Lapse Prior to Assumption 38
3. Ipso Facto Clauses 38
B. Status of the Contract After Filing, but Before Action on Assumption or Rejection 38
C. Procedure 39
1. Timing 39
2. Non-actionable Contracts 40
3. Standards 40
4. All or Nothing (But Really What Can be Negotiated) 40
D. Assignment of Assumed Contracts 41
E. Effect of Contract Rejection 41
F. Breach of an Executory Contract After Assumption 42
G. Options for Contractors and Suppliers 42

XIII. Setoff and Recoupment 43
A. Recognition and Effect of Setoff and Recoupment 43
B. Setoff 43
C. Recoupment 44
D. Setoff and Preferences 45
E. Practical Application of Setoff and Recoupment 45
XIV. Avoidance Actions Arising under Chapter 5 of the Bankruptcy Code. 45
A. Procedure 46
B. The Strong-Arm Powers 46
C. Lien Avoidance Powers 46
D. Fraudulent Transfers 47
1. Use of the Uniform Fraudulent Transfer Act or Bankruptcy Code Section 548? 47
2. Elements of Fraudulent Transfer Action 47
E. Avoiding Unauthorized Post-Petition Transfers 49
F. Avoiding Preferential Transfers 49
1. Defining a Preferential Transfer 49
2. Defenses to a Preference Claim 49
a. Substantially Contemporaneous Transactions - §547(c)(1) 50
b. Payments Made in the Ordinary Course of Business- §547(c)(2) 50
c. Subsequent New Value - §547(c)(4) 51
d. The Fixing of a Statutory Lien - §547(c)(6) 52
XV. Development and Presentation of a Plan of Reorganization 52
A. Plan Development as a Negotiation 52
B. Preparation of the Disclosure Statement 52
C. Development of a Plan of Reorganization 53
D. Invoking the Absolute Priority Rule 54
E. Issue and Claims Preclusion 54
F. Once Its Over 54
XVI. Conclusion 54

Issues Commonly Arising in Commercial Construction Bankruptcies

I. Introduction

The number of bankruptcy cases filed is climbing after reaching a recent low during 2006. According to a press release dated November 24, 2009 from the Administrative Office of the United States Courts, the total number of bankruptcy cases filed for the year ending September 30, 2009 was 34% higher than the preceding year. Business-related cases increased by 52%, and Chapter 11 filings by 68%. Locally, analysis of the case statistics reported by the Northern District of Texas during the same October to September period reveals that the total number of cases has increased by a slightly lower percentage (27%). However, the number of cases filed under Chapter 11 increased during this period by 91%. (to a total of 442).

Although bankruptcy still follows the familiar pattern laid down by Chapters 7, 11, and 13, less frequently Chapter 12 (family farmers) and even more less frequently Chapter 9 (municipalities)and Chapter 15(cross border insolvencies), aspects of the bankruptcy process have significantly changed. In part this results from the amendment of the Bankruptcy Code by the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* ("BAPCPA"). However, the adaptation of the bankruptcy process to the business environment in which bankruptcy filings take place is equally significant. The overall effect of these changes appears to have decreased the maneuverability of debtors, increased the influence of secured creditors, and reduced the prospect for a true reorganization in many cases.

II. Changes in the Landscape Since the Last Wave of Real Estate Bankruptcies

A. External Changes in the Financial Environment

The contraction in the credit markets beginning in 2008 significantly impacted bankruptcies in several ways. The decline in value of the real property has left debtors with little or no equity in property securing the bulk of their debt. This circumstance coincided with fewer lenders willing to engage in debtor-in-possession financing. Ben Levisohn, *Fewer Lifelines for the Bankrupt*, Bus.Wk., Jan. 19, 2009, at 22; *Double DIP: Bankruptcy Loans Scarce and Scary Expensive*, Fin. Wk., Jan. 19, 2009. Augmenting these factors is the changing nature of lending itself, with more development financing coming from hedge funds and Real Estate Development Trusts ("REITs") rather than more traditional sources such as banks and pension funds. *See* Harvey R. Miller, *Chapter 11 in Transition - From Boom to Bust and Into the Future*, 81 Am. Bankr. L.J. 375 (Fall 2007)("In 1995, banks represented over 70% of the investors in loans. Today, that number stands at under 13%. Conversely, in 1995, collateralized loan obligations ("CLOs"), hedge funds, and other such funds represented just over 16% of the investors in loans. Today, that number stands at over 77%.") Finally, many of these non-traditional lenders advanced money under a "loan to own" scenario, and seem as happy to gain control of the debtor's assets to get paid. (Illustrated by the use of "bad boy" guaranties which only come into play if a bankruptcy case is filed, thus discouraging owners from ever initiating a case.)

Consequently, debtors appear to have less free cash with which to work, resulting in fewer true reorganizations. Cases filed under Chapter 11 reorganization often end with a sale free and clear of liens and interests pursuant to § 363 rather than confirmation of a plan of reorganization under §1129.

B. Internal Changes within the Bankruptcy Code

Unlike the enactment of the Bankruptcy Code, BAPCPA was the product of micro-legislation or "tweaking" of existing law by various interest groups seeking specific changes. Former Judge Frank Monroe of the Western District of Texas put it more colorfully stating:

> Those responsible for the passing of the Act did all in their power to avoid the proffered input from sitting United States Bankruptcy Judges, various professors of bankruptcy law at distinguished universities, and many professional associations filled with the best of the bankruptcy lawyers in the country as to the perceived flaws in the Act. This is because the parties pushing the passage of the Act had their own agenda.

In re Sosa, 363 B.R. 113 (Bankr. W.D. Tex 2005). As a result, although it was ultimately the product of four different efforts at bankruptcy "reform"in the United States Senate and six in the United States House of Representatives, BAPCPA lacks cohesion, and its various parts do not always work well with each other. These problems are illustrated most simply by reference to BAPCPA's grammatical mysteries that still require judicial action to explain. (For example, one need only look to the "hanging paragraph" at the end of § 1325(a) relating to the treatment of auto lenders' claims).

Despite this criticism, and the fact that they were probably never intended as the beneficiaries, ***BAPCPA contains a number of changes improving the position of contractors and suppliers in bankruptcy cases.*** The most significant statutory changes include:

1) the creation of a federal reclamation right (although this is not as useful as it first appears) (§ 546);

2) the recognition of an administrative priority claim for goods delivered to the debtor during the 20 days before bankruptcy is filed (§ 503(b)(9));

3) amendment of the ordinary course of business preference defense to allow payment to be ***either*** in the ordinary course of the creditor's relationship with the debtor ***or*** in the ordinary course of the parties' industry, rather than both (§ 547(c)); and

4) addition of a *de minimis* provision requiring that Debtors-in-Possession (or more commonly Chapter 7 Trustees) bring preference claims seeking recovery of less $10,950 in non-consumer debt and $16,425 in consumer debt from a non-insider in the district where the creditor is located and not where the bankruptcy case is filed. (28 U.S.C. 1409(b)).

5) addition of a *de minimis* preference defense in non-consumer cases exempting payments of less than $5,475 from recovery by the Debtor-in-Possession or Trustee (§ 547(c)(9)).

Additional changes were made to the executory contract and lift stay provisions. However, these

changes relate primarily to lessors of commercial real estate and seem less likely to directly impact contractors and suppliers.

BAPCPA additionally modified Chapter 11 by enacting two new provisions that can impact the progress of a construction related case through Chapter 11. The first modified specific provisions relating to real estate cases involving a single asset. Single asset cases have concerned bankruptcy courts since the 1980's. *See In re Little Creek Dev. Co.*, 779 F.2d 1068 (5th Cir. 1986). As a result the Bankruptcy Reform Act of 1994 created a definition for single assets cases (§101(51B)) and modified § 362(d) to established special treatment of single assets cases in the context of modification of the automatic stay. BAPCPA modified the definition of a single asset real estate case found at §101(51B) by eliminating the $4 million cap on secured debt established in 1994, thereby subjecting larger cases to the special automatic stay provisions to pressure single asset debtors to speedily present a plan or risk termination of the stay. The second BAPCPA provision applies only to a "small business," essentially defined as debtor engaged in commercial or business activities having total debt to non-insiders of less than $2,190,000. (§101(51D)). Small business debtors are now required to proceed under these provisions if they apply (rather than having the option to apply them.) The small business provisions generally increase the administrative requirements placed on the debtor to insure that more information is available to creditors, and accelerate the timetable within which the small business must propose and seek confirmation of a plan.

Both provisions addressed perceived inequities resulting from the length of time debtors were sheltered within the protection of bankruptcy. Thus, both provisions accelerate the time within which the debtor must present and confirm plans of reorganization, and in the case of the single asset cases, accelerate the secured creditors' abilities to terminate the stay. These issues seem unlikely to directly affect contractors and suppliers. Indeed, to the extent that reorganizations, as opposed to liquidations, have declined, BAPCPA has not necessarily proven helpful to the construction community despite the positive effect of certain specific changes.

C. Changes in Case law

1. Expansion of Issue Preclusion and Claim Preclusion

Bankruptcy courts must deal with competing interests in an accelerated format. On one hand, bankruptcy courts are equity courts. *Atlantic Coast Line R.R. v. St. Joe Paper Co.*, 216 F.2d 832, 833 (5th Cir. 1954), *cert. denied,* 348 U.S. 396 (1955). On the other hand, bankruptcy courts are greatly concerned with the finality of their decisions, and the related issues of notice and due process. The compromises reached from these competing tensions seem to require increasing vigilance from parties having notice of matters occurring in bankruptcy court.

At least in the Fifth Circuit, the issue preclusive effect of final bankruptcy orders has long been found to override other considerations. Thus, in *Republic Bank v. Shoaf*, 815 F.2d 1046 (5th Cir. 1987), the Fifth Circuit enforced a discharge granted to a non-debtor guarantor in the debtor's confirmed plan of reorganization despite the fact that § 524(e) states that the discharge of the debtor will not affect non-debtor obligations. The importance afforded finality by giving preclusive effect to Bankruptcy Court orders has grown. Last year, the United States Supreme Court affirmed the bankruptcy court's decision enforcing orders entered in 1986 connection with the confirmation of the plan of reorganization in the Johns Manville Corp. bankruptcy. *Travelers Indemnity Company v. Bailey*, 129 S. Ct. 2195 (2009). The 1986 orders in issue

released insurance companies contributing to an asbestosis settlement and channeled claims into the resulting settlement fund. The Supreme Court upheld the bankruptcy court's finding that efforts by non-debtor third parties to pursue direct suits against settling insurance companies for their own actions (and not those of their insureds) were barred by the 1986 orders. In reaching its decision, the Supreme Court relied, at least in part, on the claim preclusive effect of the 1986 orders, as applied by the bankruptcy court. (The Supreme Court left certain jurisdictional questions unresolved in reaching its decision.)

Currently, the Supreme Court has under consideration the decision of the Ninth Circuit in *Espinoza v. United Student Aid Funds, Inc.*,530 F.3d 895 (9th Cir. 2008) *cert granted sub nom. United Student Aid Funds, Inc. v. Espinosa*, 129 S. Ct. 2791 (2009). An issue before the Supreme Court is whether the confirmation of a Chapter 13 plan providing for the discharge of student loan debt without otherwise complying with the requirements of Chapter 13 precludes claims by the holder of the discharged loan who, despite notice, did not appear and object. Consequently, further guidance on issue and claim preclusion in bankruptcy is expected shortly. *Espinoza* is also part of a recent trend in which the Supreme Court is considering issues in Chapter 13 cases which, due to the similarity of the language in sections of Chapter 11 and Chapter 13, will impact Chapter 11 practice

2. Ability to Issue Money Judgment in Discharge Litigation

Another recent change has been the decision of the Fifth Circuit to join the Second, Sixth, Seventh Eighth and Ninth Circuits in holding that the Bankruptcy Court has jurisdiction to award a money judgment to a creditor prevailing in a dischargeability case, rather than just declaring whether the debt is non-dischargeable. *Morrison v. Western Builders of Amarillo (In re Morrison),* 555 F.3d 473 (5th Cir. 2009). As a result, creditors filing actions seeking to determine the non-dischargeability of a debt should now also include in the complaint a request for entry of judgment on the claim. Doing so will avoid the need to refile suit to obtain a judgment, and avoid any possibility of losing the underlying claim to limitations.

3. Examiners

The use of examiners appears to be increasing, along with an expansion of the powers granted to them by the courts. An examiner may be appointed in a chapter 11 case where no trustee has been appointed. (§ 1104). An examiner may be appointed upon motion made by a party in interest in the case, or the United States Trustee, at any time between the filing of the case and the confirmation of a plan (Bankruptcy Rule 2007). The primary grounds considered by the court are whether appointment of an examiner is in the best interests of the creditors, equity security holders, or other interests of the estate. A non-exclusive list of circumstances justifying appointment includes:

1) fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or

2) the existence of grounds exist to convert or dismiss the case under § 1112;

(§ 1104(a)). Appointment is discretionary with the court except where the debtor's fixed liquidated unsecured debts (excluding debts for goods, services, and taxes or debts owing to an insider) exceed

$5,000,000, in which case an examiner must be appointed upon the request of a party in interest. (§ 1104(c)(2)).

Generally, an examiner will be authorized to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan."(§ 1106(a)(3)). However, the Court can define the scope of the examiner's duties to include any or all of these responsibilities. *In re UAL Corp.*, 307 B.R. 80 (Bankr. N.D. Ill. 2004). Indeed, the statutory provision authorizing an examiner to investigate "any other matter relevant to the case or to the formulation of a plan" has formed the basis for the appointment of an examiner to undertake any matter as to which the bankruptcy court itself has jurisdiction. *In re Mirant Corp.,* Case No. 03-46590, 2004 Bankr. LEXIS 1654 (Bankr. N.D. Tex. Sept. 1, 2004) (summarizing cases appointing examiners with wide powers at footnotes 6 and 7); *See also* Elizabeth Warren and Jay Westbrook, *Examining the Examiner*, 24-4 ABIJ 34 (May 1, 2005).

An examiner may be a useful part of the bankruptcy process. In particular, an examiner can be used to investigate sensitive areas of the debtors business where creditors, or employees, of the debtor are not willing to simply "trust" the debtor's conclusions regarding case-related choices. However, appointment of an examiner will add costs to a Chapter 11 case, and the benefits must be weighed against these costs by the court and creditors. In many cases, these costs simply cannot be justified.

4. Impact of *In re General Growth Properties, Inc.*

General Growth Properties, Inc., which owned or managed 200 million square feet of retail space, filed bankruptcy in April 2009, initiating perhaps the largest real estate bankruptcy filed to date. General Growth placed not only insolvent subsidiaries, but also solvent special purpose entities, into bankruptcy. The creditors of those solvent entities challenged the bankruptcy filings and sought to dismiss the bankruptcy filings of the solvent special purpose entities. Recently, the court entered its decision on those objections in *In re General Growth Properties, Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009)). The Bankruptcy Court held that judgment on an issue as sensitive and fact-specific as whether to file a Chapter 11 petition can be based in good faith on consideration of the interests of the group as well as the interests of the individual debtor. The decision may turn on specific provisions of the loan documents in issue and Delaware law, rather than broader bankruptcy policy. ***However, the main point of concern to contractors and suppliers from this decision is that a solvent customer's insolvent affiliate may generate a bankruptcy filing for both.***

III. Basic Principles of Bankruptcy

A. The Automatic Stay

Perhaps the most fundamental feature of bankruptcy law is the automatic stay. The stay is an injunction that arises upon the filing of the case, prohibiting creditors from taking eight specified actions against the debtor and the debtor's property. (§362(a)). Rather than detail the specific scope of the stay, it is sufficient to say that the stay broadly prevents almost all of the actions which a contractor or supplier creditor would like to take. ***There are exceptions to the stay detailed in §362(b). Most notably with respect to construction related cases, the stay does not prevent acts taken to perfect a mechanic's lien. See §§ 362(b)(3) and 546(b).***

The stay is effective regardless of whether a creditor has actual notice that a case has been filed.

In re Waters, 22 B.R. 387 (Bankr. N.D. Tex. 1982); *In re Miller*, 22 B.R. 479 (D.C. Md. 1982); *In re Sandmar Corp.*, 12 B.R. 910 (Bankr. D.N.M. 1981). Actions taken in violation of the stay may be avoided. Many jurisdictions hold that actions in violation of the stay are simply void. However, the Fifth Circuit considers them voidable because the bankruptcy court has the power to annul the automatic stay pursuant to § 362(d). *Chapman v. Bituminous Ins. Co. (In re Coho Res., Inc.)*, 345 F.3d 338, 344 (5th Cir. 2003); *Picco v. Global Marine Drilling Co.*, 900 F.2d 846, 850 (5th Cir. 1990). An individual debtor injured by a willful violation of the stay may recover actual damages, attorneys' fees and costs, and punitive damages. (§362(h)). While non-individual debtors are not expressly included within the scope of damages allowed by §362(h), damages for violation of the stay in corporate cases can be awarded under § 105. S*ee In re Spookyworld, Inc*., 346 F.3d 1 (1st Cir. 2003).

A co-debtor stay is available in chapter 12 and 13 cases to persons liable with the debtor on an obligation of the type specified in §§ 1201 and 1301. Otherwise, the stay does not extend to non-debtors. *Kreisler v. Goldberg*, 478 F.3d 209 (4th Cir. 2007). In limited circumstances, the automatic stay can apply to the debtor in such a way as to indirectly benefit non-debtors. *See In re First Fin. Group, Inc.*, 3 B.R. 375 (S.D. Tex. 1980) (applying automatic stay to debtor's co-defendants when suit against was "inextricably interwoven" with claims against the debtor). Under § 105, the court may also extend the stay to non debtors if it determines that the debtor would suffer some cognizable prejudice if an injunction expanding the stay were not granted. *In re Bidermann Indus. U.S.A., Inc*., 200 B.R. 779, 782 (Bankr. S.D.N.Y. 1996); *In re All Seasons Resorts, Inc.*, 79 B.R. 901, 903-904 (Bankr. C.D. Cal. 1987). These circumstances are rare.

As a result of the BAPCPA amendments in 2005, the automatic stay is no longer always automatic. As applied to cases filed by individuals, the stay may not arise, or may terminate 30 days after the case is filed if the debtor has previously filed bankruptcy during the preceding year. In such cases the debtor must ask the court to impose the stay after a hearing and a demonstration that the filing was made in good faith. These issues most commonly arise in serial Chapter 13 cases. In the construction context, the effect of the BAPCPA amendments is more likely to arise in the context of a small business case. (§ 362(n)) The automatic stay would not apply in a small business case if the debtor has another case pending simultaneously (presumably the stay in that case would be in effect), and the stay would not operate if the debtor was in a small business case that was dismissed within two years of the order for relief in the second case, or if the debtor had a plan confirmed in a small business case within two years of the new case. The provision also applies if an entity acquired all or substantially all of the assets in a small business of the kinds described above. The debtor can overcome this denial of the automatic stay upon a showing by a preponderance of the evidence that the second bankruptcy filing resulted from circumstances beyond the debtor's control, and that the court will confirm a plan, other than a liquidating plan, in a reasonable time.

A creditor may obtain relief from stay, for cause, including lack of adequate protection of its interest in the collateral, lack of equity in the property by the debtor, or that the property is not needed for an effective reorganization. (§362(d)) "Cause" is not defined in the Bankruptcy Code but is to be "determined on a case-by-case basis." *International Business Machines v. Fernstrom Storage and Van Co.,* 938 F.2d 731,735 (7th Cir.1991) (citing *In re Tuscan Estates*, 912 F.2d 1162, 1166 (9th Cir.1990)). The legislative history indicates that cause may be established by a single factor such as "a desire to permit an action to proceed ... in another tribunal," or "lack of any connection with or interference with the pending bankruptcy case." H.R.Rep. No. 95-595, 95th Cong., 1st Sess., 343-344 (1977) *U.S.Code Cong. & Admin.News* pp. 5787, 6300. See also *In re Drexel Burnham Lambert Group, Inc.*, 113 B.R. 830, 838 n. 8 (Bankr. S.D.N.Y. 1990) (citing various findings of s 362(d)(1) "cause" to permit litigation in another forum such as liquidation of a personal injury, arbitration or specialized jurisdiction claim). The creditor has the burden of proving a lack of equity

in the collateral; the debtor has the burden of proof as to all other issues. The stay terminates thirty (30) days after relief is sought by motion filed with the court unless the court orders it continued pending a final hearing. (§362(e)). The final hearing must conclude within thirty (30) days of a preliminary hearing, unless the parties consent to extend the deadline or the court finds compelling circumstances to continue the stay. *Id.*

The effect of the stay must always be taken into careful account, as it can operate in some unusual ways. Thus, cancellation of a contract is stayed even if the contract permits cancellation because rights under a contract are property right of the estate. An administrative freeze of a bank account does not violate the automatic stay. See *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 116 S. Ct.286, 133 L. Ed. 2d 258 (1995). However actually implementing a setoff in connection with the administrative freeze will violate the stay. (§362(a)(7)). The stay does not protect third parties (beyond the co-debtor stay discussed above) except in circumstances where the debtor is the real party in interest. *In A.H. Robins Co. v. Piccinin*, 788 F.2d 994 (4th Cir. 1985) (actions against debtor's officers and directors, who had indemnification rights against the debtor's limited insurance fund, were subject to the stay.) The filing of UCC continuation statements is not subject to the stay, but the initial filing of a UCC financing statement violates the stay unless it occurs within ten (10) days of the debtor acquiring rights in the collateral.

B. The Estate and the Debtor are not the Same

By operation of law, when a bankruptcy is filed, the assets of the party filing the bankruptcy are immediately transferred to the "bankruptcy estate" of the filing party. (§ 541). The estate of a Chapter 13 debtor is larger in that it includes property acquired after the petition date. (§ 1306). The estate is an entity legally distinct from the debtor and serves as the vehicle through which the entire bankruptcy proceeding is then administered. *In re Swift Aire Lines, Inc.,* 30 B.R. 490, 495 (9th Cir. BAP 1983); *In re Dow Corning Corp.,* 270 B.R. 393, 398-99 (Bankr. E.D. Mich. 2001); *In re Roy Stanley, Inc.,* 217 B.R. 23, 25 (Bankr. N.D.N.Y. 1997); *In re Seaescape Cruises, Ltd.,* 201 B.R. 321, 323 (Bankr. S.D. Fla. 1996).

Property of the estate exists independently of management of that property. The Bankruptcy Code defines all management rights in estate property with reference to the Trustee in the context of a Chapter 7. In a Chapter 7 case, the United States Trustee's Office for the District where the case is filed appoints a Chapter 7 Trustee from a panel that it maintains. This Chapter 7 Trustee assumes the management of the debtor's non-exempt property and is a fiduciary for the creditors. The person or entity filing a chapter 11 case is normally the debtor-in-possession, or "DIP." In a Chapter 11, the DIP continues to operate the estate property and is empowered with the same rights, duties, and obligations as the Trustee in a chapter 7 case. (§1107(a)). (A Chapter 13 debtor is not subject to the same fiduciary obligations). Thus, although not all of the sins of the pre-petition debtor are washed clean, the transfer of the pre-petition debtor's property to the bankruptcy estate in effect works a baptism of the property so that the inherent value of the pre-petition debtor is born again with rights generally not impaired by the debtor's pre-petition conduct. Although it is often taken for granted or overlooked, this transfer and the creation of a new entity in the form of the estate is the fundamental theoretical underpinning for much that follows, as discussed below.

C. Property that Belongs to the Debtor Now Belongs to the Estate

Section § 541 enumerates the assets that are transferred to the estate, and thus subject to administration by the estate. *Bradley v. Ingalls (In re Bradley)*, 501 F.3d 421, 428 (5th Cir. Tex. 2007). The general rule is that all legal or equitable interests of the pre-petition debtor become property of the estate,

even if the debtor has no equity in such property. *Id* at 428. Although this transfer takes place by operation of the Bankruptcy Code, and the type of interests constituting "property of the estate" is a matter of federal law, the extent of interests in property is created and defined by state law. See *Butner v. United States*, 440 U.S. 48 (1979). Once an asset becomes part of the bankruptcy estate, all rights held by the debtor in the asset are extinguished unless the asset is abandoned by the trustee to the debtor pursuant to § 554. *Parker v. Wendy's Int'l, Inc.,* 365 F.3d 1268, 1272 (11th Cir. 2004). At the close of the bankruptcy case, property of the estate that is not abandoned under § 554 and that is not administered in the bankruptcy proceedings remains the property of the estate. (§ 554(d)). As discussed in more detail below, where the debtor fails to list an interest on a bankruptcy schedule, that debtor cannot reacquire the property and it remains in the bankruptcy estate, subject to later reopening and administration. *Kane v. Nat'l Union Fire Ins. Co*., 535 F.3d 380, 385 (5th Cir. 2008).

D. Property that Never Belonged to the Debtor Cannot Belong to the Estate

Despite the expansive definition of property of the estate, not everything is included. Section 541(a)(1) provides in pertinent part that property in which the debtor holds " 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." Property that does not become property of the estate appears in the construction context in a number of forms.

1. Trust Fund and Earmarking-Benefits and Limitations

Money held by the pre-petition debtor for another does not become property of the estate. Such funds may be placed outside of the debtor's property interest pursuant to an express agreement (such as a joint check agreement as discussed below) or constructively pursuant to state trust fund law. *In re Haber Oil Co.,* 12 F.3d 426, 436 (5th Cir.1994); *In re Sakowitz, Inc.,* 949 F.2d 178, 181 (5th Cir.1991); *Georgia Pacific Corp. v. Sigma Service Corp.*, 712 F.2d 962, 965-68 (5th Cir.1983). In particular, Texas law provides that funds paid to a contractor or subcontractor are held in trust for those mechanics, materialmen, artisans and other laborers who have worked on a given construction project. *See* TEXAS PROPERTY CODE § 162.001 *et seq.* In *Vulcan Materials Company v. Jack Raus, Inc.*(*In re HLW Enterprises of Texas, Inc.*),157 B.R. 592 (W.D. Tex 1993), the Bankruptcy Court for the Western District of Texas concluded that "once the owner makes a payment to *either* the general contractor or to a subcontractor, that payment gives rise to a trust for all parties in the subcontract chain." As a result, the court concluded that the debtor subcontractor had no rights to "trust funds" until it could demonstrate payment to its materials supplier. See also *Lowe v. Palmetco, Inc. (In re NA Flash Found., Inc.)*, 541 F.3d 385 (5th Cir. 2008)

The earmarking or conduit doctrine holds that funds are not property of the estate, even if the debtor held them in an account in the debtor's name, if the funds were intended to be transferred to a non-debtor third party *and* the debtor never exercised control or possession over the funds. *Caillouet v. First Bank & Trust (In re Entringer Bakeries Inc.)*, 548 F.3d 344 (5th Cir. La. 2008); *Coral Petroleum, Inc. v. Banque Paribas London*, 797 F.2d 1351, 1356 (5th Cir. 1986); *Smith v. Suarez (In re IFS Fin. Corp.)*, 417 B.R. 419, 435-436(Bankr. S.D. Tex. 2009). Thus, payments made by a contractor to the supplier of a bankrupt subcontractor may not be part of the subcontractor's bankruptcy estate if the contractor has an independent obligation to pay the supplier. *In re Flooring Concepts, Inc.,* 37 B.R. 957, 961 (9th Cir. BAP 1984); *Keenan Pipe & Supply Co. v. Shields,* 241 F.2d 486, 489-90 (9th Cir.1956). This type of independent obligation can arise from a joint check agreement or other contractual provisions obligating the general

contractor to pay subcontractors. The court in *In re LWMcK Corp.*, 196 B.R. 421, (Bankr.S.D.Ill. 1996) found that the language in the contract between the general contractor and the debtor sub-contractor which permitted the general contractor to withhold from the sub-contractor funds necessary to pay lien claims was sufficient to give rise to the necessary independent obligation.

However, these doctrines have significant practical limitations that will limited their usefulness and make them more expensive to establish. *See Lovett v. Homrich,Inc. (In re Philip Servs. Corp.),* 359 B.R. 616, 628 (Bankr. S.D. Tex. 2006)(Applying Michigan Trust Fund Statute); *Cunningham v. T&R Demolition, Inc. (In re ML & Assoc., Inc.),* 301 B.R. 195, 200 (Bankr. N.D. Tex. 2003); *Rodriguez v. Consol. Elec. Distribs., Inc. (In re Martin Wright Elec. Co.)*, 2008 Bankr. LEXIS 82 (Bankr. W.D. Tex. Jan. 9, 2008); See also John T. Gregg, *Limitations on the Use of Statutory Builders Trusts as Protection Against Preferential Transfers*, 26-7 ABIJ 20 (September 1, 2007). In each of these cases, the court recognized that the payments made to the contractor or supplier by the debtor might not be property of the estate, but required the non-debtor to establish this by tracing the claimed trust funds for the entire relevant period using an accepted method of tracing. Typically, tracing is accomplished by application of the " lowest intermediate balance" rule). *In re Al Copeland Enterprises, Inc.,* 133 B.R. 837, 840 (Bankr. W.D. Tex. 1991) (opinion of the bankruptcy court) *aff'd by Matter of Al Copeland Enters., Inc.,* 991 F.2d 233 (5th Cir. 1993).

2. Joint Check Agreements

A joint check agreement (or even an individual joint check) may create the form of express trust needed to prevent payment thereunder from becoming property of the estate. *See Guttman v. Impulse NC, Inc. (In re Railworks Corp.)*, 387 B.R. 156 (Bankr. D. Md. 2008); *Herzog v. Sunarhauserman* (*In re Network 90 Degrees, Inc).*, 98 B.R. 821 (Bankr. N.D. Ill. 1989), *aff'd* 126 Bankr. 990 (N.D.Ill. 1991); *In re Temp-Way Corp.*, 80 B.R. 699 (Bankr. E.D. Penn 1987); *Diamond K. Corp. v. Alpha Concrete, Inc. (In re Diamond K. Corp.)*, 2007 Bankr. LEXIS 2608 (Bankr. E.D. Tex. Aug. 2, 2007). However, analysis of joint check situations is intricately entangled with application of the trust fund and earmarking doctrines.

The Fifth Circuit held that absent something more the proceeds of a check issued jointly, but not pursuant to a written joint check agreement, are part of the bankruptcy estate. That something more would be circumstances where the debtor acted as a trustee or a mere conduit (in fact or implied in law), or where the material supplier acted in reliance on the joint-check agreement in supplying the debtor with materials. *Georgia Pacific Corp. v. Sigma Service Corp. at* 972. For further discussion of joint check agreements and joint check issues see Michael B. Lubic and Jennifer M. Phelps, *Contractors' Joint Check Agreements: Use at Your Peril,* 20 AM. BANKR. INST. J. 16 (March 2001).

An additional problem can arise in connection with joint check agreements implemented at some time other than the commencement of the parties' relationship. The act of signing a joint check agreement might be a preferential transfer if it takes place in the 90 days prior to the filing of a bankruptcy. *In re Buono,* 119 B.R. 498 (Bankr. W.D. Pa. 1990). However, in a state with a trust fund statute, the funds subject to the joint check agreement may be trust funds, with the joint check agreement and the short timetable making the tracing issues discussed above less burdensome to establish.

E. Types of Proceedings in Bankruptcy--Motion Practice (Contested Matters) or Trials (Adversary Proceedings)

Adversary proceedings are essentially federal court lawsuits conducted in the Bankruptcy Court, typically on an accelerated basis. Adversary proceedings are initiated by the filing of a complaint, whereupon they are assigned a separate case number from the main bankruptcy and proceed in accordance with the Federal Rules of Civil Procedure as made incorporated into bankruptcy by Part VII of the Bankruptcy Rules. Bankruptcy Rule 7001 defines ten types of actions as adversary proceedings:

1. to recover money or property, except a proceeding to compel the debtor to deliver property to the trustee, or a proceeding under § 554(b) or § 725 of the Code, Rule 2017, or Rule 6002;
2. to determine the validity, priority, or extent of a lien or other interest in property, other than a proceeding under Rule 4003(d);
3. to obtain approval pursuant to § 363(h) for the sale of both the interest of the estate and of a co-owner in property;
4. to object to or revoke a discharge;
5. to revoke an order of confirmation of a chapter 11, chapter 12, or chapter 13 plan;
6. to determine the dischargeability of a debt;
7. to obtain an injunction or other equitable relief;
8. to subordinate any allowed claim or interest, except when subordination is provided in a chapter 9, 11, 12, or 13 plan;
9. to obtain a declaratory judgment relating to any of the foregoing; or
10. to determine a claim or cause of action removed pursuant to 28 U.S.C. § 1452.

Contested matters consist of everything that is not an adversary proceeding. Contested matters proceed under Bankruptcy Rule 9014. Bankruptcy Rule 9014(c) incorporates certain of the Federal Rules of Civil Procedure by incorporation of some, but not all, of the rules governing adversary proceedings found the Part VII of the Bankruptcy Rules. Contested matters are what most trial attorneys would consider motion practice. However, except where varied by specific local rule or practice, contested matters are full evidentiary hearings with witnesses presented as they would be at a trial in an adversary case. Bankruptcy Rule 9014(d). A hearing in a contested matter, particularly consideration of a major issue such confirmation of a plan of reorganization, may last several days or even longer, and be effectively indistinguishable from a bench trial with multiple parties. Most of the courtroom activity in a bankruptcy case relates to the presentation of contested matters, and relatively few issues will be presented as adversary proceedings. Solely for purposes of illustration, during the year ending September 30, 2009, the total number of bankruptcy cases filed in the Northern District of Texas was 19,483 (each spawning numerous contested matter hearings), compared to 1,661 adversary cases.

F. Discovery and Evidence in Bankruptcy

Information is an important commodity in bankruptcy cases. Most creditors' counsel have experienced frustration in communicating with the debtor's counsel. The nature of a practice handling Chapter 7 and Chapter 13 cases does make it harder to obtain information voluntarily from the debtor or debtor's counsel. The degree of openness may also restricted by court order with regard to aspects of the debtor's operation that may involve trade secrets the preservation of which makes the debtor's property more valuable or improves reorganization prospects. A surprising amount is available directly from

documents filed with the court, and at least in Chapter 11 cases, simply by asking. However, at times discovery is necessary, and different forms of discovery are available during different phases of the case.

1. Administrative Discovery

Administrative discovery may take place during the course of the case for various reasons. The first opportunity is the meeting of creditors pursuant to § 341. This meeting, which occurs early in the case, permits questioning of the debtor's representative under oath about anything relating to the bankruptcy. However, given the circumstances under which it is conducted - usually with a large number of meetings scheduled sequentially with either the Trustee in a Chapter 7 and 13, or the United States Trustee in the case of Chapter 11 - creditors are not free to conduct a deposition. A meeting of creditors is best used as a tool to raise the Trustee's awareness of specific issues, or obtain an answer to a few specific questions. It is rare that a creditor would be allowed more than a few minutes during which to ask questions.

Instead, if more time is needed, the creditor may ask for an examination under Bankruptcy Rule 2004. The purpose of Bankruptcy Rule 2004 is to allow examination of any person who may have knowledge of the debtor's affairs. *See In re Nixon Electric Supply. Inc.*, 85 B.R. 988 (Bankr. W.D. Tex. 1988). Most authority indicates that 2004 examination is a one-way discovery device for creditors and trustee. However, some courts have allowed the debtor to utilize a 2004 examination. *In re Public Servo Co.*. 91 B.R. 198 (Bankr. D.N.H. 1988); *In re Sutera*, 141 B.R. 539 (Bankr. D. Conn. 1992). The scope of inquiry is intended to be broad. *In re Continental Forge Co.*, 73 B.R. 1005 (Bankr. W.D. Pa. 1987); *In re GHR Energy Corp.*, 33 B.R. 451, 453 (Bankr. D. Mass. 1983). Bankruptcy Rule 2004 allows a motion requesting an examination to be heard *ex parte*, but as a practical matter most local rules will require conference with the debtor's counsel.

2. Discovery Related to Proceedings

The various rules in Part VII of the Bankruptcy Rules (the 7000 series) adopt certain corresponding Federal Rules of Civil Procedure ("FRCP"). Thus, Bankruptcy Rule 7004 incorporates Federal Rule of Civil Procedure 4, and so on, with some variation. Bankruptcy Rules 7030 through 7037 adopt the basic discovery provisions of FRCP Rules 30 through 37, thus providing for oral depositions, depositions on written questions, interrogatories, requests for production, examinations, requests for admission, and discovery sanctions. These same discovery tools are available in the context of a contested matter, with the exception that the disclosure requirements of FRCP 26 do not apply. The timing provisions of certain of the discovery rules (allowing a 30 day response period) can be awkward in the context of a contested matter, placing more emphasis on those procedures requiring shorter notice (such as depositions). However, local rules may shorten the time periods. For example, Rule 4001 of the Local Rules of the Bankruptcy Courts for the Northern District of Texas shortens the responses time for discovery requests related to automatic stay issues under Bankruptcy Rules 7028-7036 from 30 to 12 days, and authorizes depositions to be taken upon the expiration of 10 calendar days after service of the motion for relief from the automatic stay. Contested matters also require the exchange of witness and exhibit lists and other "pretrial" information and are often augmented by local rules.

3. The Rules of Evidence in Bankruptcy

As a result of many conventions commonly used in bankruptcy court, such as the proffer of evidence, and the absence of a jury, non-bankruptcy practitioners surmise that there are no rules of evidence in bankruptcy proceedings. However, this is not correct and Bankruptcy Rule 9017 incorporates

the Federal Rules of Evidence into bankruptcy cases. The level of enforcement of specific rules varies with the circumstances, just as it does in all courts, but the rules of evidence are generally enforced. Judge Barry Russell of the Central District of California has authored the *Bankruptcy Evidence Manual* detailing the use of the rules of evidence in the bankruptcy courts, and this reference is recommended for trial lawyers desiring further guidance on this topic.

G. The Effect of Bankruptcy Code § 108(c) on Statutes of Limitations

An often overlooked aspect of bankruptcy law is its effect on deadlines, such as appellate timetables and statutes of limitation of claims that creditors may have against the Debtor (and persons protected by co-debtor stay of § § 1201 or 1301.) Many bankruptcies fail and are resolved by dismissal without any discharge being granted. Pursuant to § 108(c), the automatic stay initiated upon the filing of the case pursuant to Bankruptcy Code 362 extends the running of any non-bankruptcy period that has not run as of the filing of the bankruptcy case until 30 days after the stay is terminated or the remaining term of the period in issue itself, whichever is longer. Bankruptcy Code § 362(c)(2) provides that the stay continues under terminated by court order, and if no order is entered, the earliest of the time the case is closed or dismissed. In considering the effect of § 108(c) following BAPCPA, it is necessary to be aware that in some cases of serial filing, the stay may not apply, or may terminate shortly after the case is filed.

It is also important to note for purposes of construction related cases that there is a seeming conflict between § 108(c) and § 546(b). In the mechanic's lien context, § 546(b) allows a creditor to continue a lien or take the steps necessary to maintain the previously perfected interest by "giving notice within the time fixed by [applicable non-bankruptcy law]." ***Since § 546(b) allows the lien creditor to take steps to perfect its interest during the bankruptcy, a lien creditor cannot rely on the tolling effect of § 108(c). Concrete Structures Inc. v. Tidewater Crane and Rigging Co. (In re Concrete Structures Inc.), 2001 U.S. Dist. LEXIS 3675 (E.D. Va. 2001),***

H. Unscheduled Property

The debtor is under a duty to accurately schedule not only its liabilities, but more importantly, its assets. However, at times, due to either neglect or intent, a debtor will fail to list property in either the schedules or disclosure and plan documents. Such omitted property may be as obvious as the debtor’s vacation home in egregious cases, but is more often an inchoate claim that at the time the case is filed seems unimportant to whomever is completing the schedules, but latter becomes so.

Assets of the pre-petition debtor that are not disclosed remain property of the estate. Indeed recently a bankruptcy court in California held that unscheduled assets in a case under the Bankruptcy Act remained property of the estate 70 years later. *In re Dunning Bros. Co.*, 410 B.R. 877 (Bankr. E.D. Cal. 2009). Consequently, if a former debtor brings a lawsuit against a creditor after a bankruptcy case is filed, but failed to list the claim as an asset in the case, the former debtor and its successors may be judicially estopped from pursuing that lawsuit. *Heritage Hotel Limited Partnership I v. Valley Bank of Nev. (In re Heritage Hotel Partnership I)*, 160 B.R. 374, 378 (B.A.P. 9th Cir. 1993), *aff'd*, 59 F.3d 175 (9th Cir. 1995). As a result, any time a former debtor (either an individual who files a case or a reorganized corporate debtor) files a lawsuit after the bankruptcy case is concluded, counsel for the defendant should review the bankruptcy court record to determine if the plaintiff is estopped from bringing the claim. The downside of such action is that it might revive a bankruptcy and substitute a trustee for the plaintiff.

IV Involuntary Petitions

A. Do You Really Want to File One?

The first issue presented in the context of bankruptcy may be whether to undertake efforts to place a party owing money into bankruptcy by filing an involuntary case. Involuntary cases can be part of an effective creditor strategy. However, before a creditor joins an involuntary filing, careful consideration should be given to what happens if the petition is not successful. The rule in considering filing an involuntary petition is well described by the Chinese proverb regarding tigers, once you try to ride one, you must remain in that position or risk being eaten if you get off. If an involuntary petition is dismissed for reasons other than the consent of all petitioners and the debtor, the Court may grant a judgment in favor of the debtor against the petitioners for costs and reasonable attorneys' fees. (§303(i)(1)). The Texas bankruptcy courts reviewing this issue have held that the decision to award fees and costs is based on consideration of the "totality of circumstances" and the reasonableness of the petitioning creditor's actions, motives, and objectives. *In re Commonwealth Sec. Corp.,* 2007 Bankr. LEXIS 312, 2007 WL 309942 (Bankr. N.D. Tex. Jan. 25, 2007); *In re Allied Riser Communs. Corp.*, 283 B.R. 420, 424 (Bankr. N.D. Tex. 2002); *In re Synergistic Techs., Inc.*, 2007 Bankr. LEXIS 2660 (Bankr. N.D. Tex. Aug. 6, 2007).

If the case is dismissed in conjunction with a finding by the court that a petitioning creditor acted in bad faith, the court may award judgment for the alleged debtor against all or any of the petitioning creditors for actual and punitive damages. (§303(i)(2)). Actual damages can include, among other things, injury resulting from the alleged debtor's inability to obtain credit, discontinuance of supply sources and deterioration of the alleged debtor's business reputation. The conduct of each of the petitioning creditors is examined separately and it is possible for a finding of bad faith to be made against one creditor with others being found to have acted properly under the Bankruptcy Code. In the Fifth Circuit, the fee shifting provisions apply only to the petitioning creditors, and not their attorneys. *In re Walden,* 787 F.2d 174, 174 (5th Cir. 1986); *Keiter v. Stracka*, 192 B.R. 150 (S.D. Tex. 1996). However, that is not true in other circuits, and in the Fifth Circuit §303(I) does not preclude independent pursuit of sanctions requests under 9011. *Id.* at 160; See also C.R. "Chip" Bowles Jr., *The Lawyer Made Me Do It! Ethical and Liability Issues for Attorneys for Petitioning Creditors in Involuntary Bankruptcies*, Part II ABI October 1, 2002.

The petitioning creditors are presumed to have acted in good faith in filing an involuntary petition, and that the alleged debtor then has a burden of proving bad faith by a preponderance of the evidence. *In re Synergistic Techs., Inc.*, 2007 Bankr. LEXIS 2660 (Bankr. N.D. Tex. Aug. 6, 2007). Bad faith (or more precisely the absence of good faith) is a term which comes up in many contexts in the Bankruptcy Code and is not defined in any of those contexts. The legislative history to §303(i)(2) discussed bad faith with reference to "frivolous...and spiteful petitions..." 130 Cong. Rec. H 7482 (June 29, 1984). As reflected in the case law, consideration of the issue of bad faith appears to focus on a variety of tests, some of which are subjective and focus on the petitioner's improper purpose or improper use of the Bankruptcy Code. *In re K.P. Enterprise,* 135 B.R. 174, 179 (Bankr. D. Me. 1992); *In re Camelot Inc.,* 25 B.R. 861, 864 (Bankr. E.D. Tenn. 1982). Other tests purport to be objective and look at what a reasonable person would have believed under the facts facing the petitioning creditors. *In re Wavelength Inc*., 61 B.R. 614, 620 (9th Cir. BAP 1986) ("what a reasonable person would have believed"). Another test looks to the standards developed in the context of Federal Rule of Civil Procedure 11 (as incorporated into bankruptcy proceedings by Bankruptcy Rule 7011), which would require finding that the request for an involuntary is not founded on existing law or is not well grounded in fact, after reasonably inquiry, in order to be bad faith. *In re Bayshore Wire Products Corp.*, 209 F.3d 100, 105-106 (2d Cir. 2000*); General Trade Inc. v. Yale Materials Handling Corp.,* 119 F.3d

1485, 1501-1502. (11th Cir. 1997). Analysis of the specific cases indicate that bad faith can be demonstrated where petitioning creditors knew or should have known that they did not meet one of the qualifications for filing an involuntary case. An example is where a creditor knew or should have known that twelve or more creditors existed and filed an involuntary petition on its own or where the petitioning creditors failed to conduct a proper investigation of whether the Debtor was paying its debts as they became due.

Conversely,§§ 503(b)(3)(A) and 503(b)(4) authorize the court to reimburse creditors for the costs incurred in connection with filling an involuntary bankruptcy petition, including reasonable attorney's fees. However, as is always the case, the debtor has to have money free of secured creditors' claims for this option to be meaningful.

B. Effect of Filing and Operations of the Alleged Debtor in the Gap

Unlike the circumstances of a voluntary petition, the filing of an involuntary petition does not immediately place the debtor under court or Trustee supervision. Although the automatic stay goes into effect, the alleged debtor can continue to operate its business and use and dispose of property unless the court restricts the such activity. (§303(f)); *In re Acelor*, 169 B.R. 764 (Bankr. S.D. Fla. 1994). This period of limbo, between the filing of an involuntary petition, and an adjudication that the alleged debtor is bankrupt (or the conversion of the case to a voluntary one), is called the "gap." The gap can last for quite some time. *In re Commonwealth Secs. Corp.*, No. 06-30746, 2007 WL 309942, at *4 (Bankr. N.D. Tex. Jan. 25, 2007) (10 month gap period). However, if the alleged debtor acts too arbitrarily or unusually in conducting its business or disposing of its assets, such as selling all of its property to an insider, the court is authorized to appoint an interim trustee to displace the alleged debtor in the management of its property. (§ 303(g)).

Claims arising from work performed or materials provided during the gap are treated differently than claims arising prior to the filing of the involuntary petition. Section 507(a)(2) grants claims arising in the gap treatment as a third administrative priority claim, which places gap creditors ahead of general unsecured creditors. However, as is always the case, administrative status is not a guaranty of payment, which requires money free of secured creditor claims.

C. The Procedural Requirements

Section 303(a) provides that an involuntary proceeding may be instituted under Chapter 7 or 11 against a "person." The term "person" is defined in § 101(41) to include individuals, partnerships, and corporations. An involuntary petition must be filed in compliance with Official Form No. B5. The petition must be verified and must allege the following elements:

1) The petitioners hold non-contingent, unsecured claims amounting to $13,475.00;

2) The alleged debtor's principal place of business, principal assets or residence have been located in the district where the case will be filed for at least 180 days, or the longer portion of the preceding 180 days than in any other district;

3) The alleged debtor must be eligible for relief under the Chapter to be filed;

4) The alleged debtor is not generally paying his debts as they come due; and
5) The petitioning creditors claims are not subject to bona fide disputes as to liability or amount.

Failure to meet these requirements deprives the bankruptcy court of subject matter jurisdiction over the debtor and its assets. *In re All Media Properties, Inc.*, 646 F.2d 193 (5th Cir. 1981).

Once a case is filed, an alleged debtor generally has 20 days after service of the summons to respond to the involuntary petition. Bankruptcy Rule 1011. If no answer is filed, an order for relief is entered by default. (§ 303(h)). The alleged debtor's response may include a request for, costs, attorneys fees, damages, and the sealing of the record. (§ 303(I) and (l)). Possible defenses include: 1) lack of jurisdiction; 2) improper venue; 3) noncontingent, undisputed indebtedness of the petitioning creditors does not meet the statutory limits; 4) insufficient number of petitioning creditors; 5) nonqualifying petitioning creditors; and 6) petitioning creditor's claim raises issues of duress, estoppel, fraud or falsity. If a response is filed, the court must then essentially conduct a trial on the elements of an involuntary before entering an order for relief (thus "commencing" the bankruptcy) or dismiss the case. Bankruptcy Rule 1013(a).

In order for an involuntary petition to be dismissed, there must be written notice to all creditors and a hearing. (§303(j)). If the dismissal is based on a settlement between the involuntary debtor and the petitioning creditors under §303(j)(2), the court must determine if the settlement is in the best interest of the estate. Moreover, "if the settlement involves something other than a cash payment, the court must determine the effect of the settlement on similarly situated creditors and, if creditors are not treated fairly and equitably, the settlement should not be approved." *In re Warren*, 181 B.R. 136, 138 (Bankr. N.D. Ala. 1995).

D. Calculation of the Holders of a Claim

The number of claim holders determines the number of creditors required to successfully file an involuntary case. Determination as to the number of claim holders against an alleged debtor is made as of the date of the bankruptcy filing. Subsequent payment to a creditor does not affect the validity of the involuntary petition or the court's jurisdiction over the debtor. The number of petitioning creditors required is determined initially by the number of "holders of claims." A "claim" is broadly defined in Code §101(5) to be a:

(a) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(b) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured.

This definition is intended to be extraordinarily broad and to encompass virtually all existing or future obligation of payment flowing from the prospective debtor to any other person, natural or corporate. Although they may hold claims, "friendly creditors", such as employees or insiders of the Debtor, in addition to transferees of certain transfers voidable under §§544, 545, 547, 548, 549 and 724 of the Bankruptcy Code, are not counted. § 303(b)(2). Therefore, although at first glance a person may have creditors considerably in excess of twelve, it may be possible through discovery or investigation to reduce this number.

Some Courts have additionally held that creditors with recurring small claims for current expenses should not be counted amongst the total number of creditors. In applying the Bankruptcy Act, which was

the law governing bankruptcy prior to 1978, the Fifth Circuit found that small and recurring claims, such as utility and telephone bills, should not be counted. *Denham v. Shellman Grain Elevator, Inc.*, 444 F.2d 1376 (5th Cir. 1971). Since the enactment of the Bankruptcy Code, the Fifth Circuit has not again addressed this issue, although it declined to overturn this result in *Matter of Runyan*, 832 F.2d 58, 60 (5th Cir. 1987). *See also In re Smith*, 415 B.R. 222 (Bankr. N.D. Tex. 2009)(excluding claims of recurring creditors up to $187.00); *In re Moss*, 249 B.R. 411, 422 (Bankr. N.D. Tex. 2000) (excluding claims of recurring creditors up to $50.00). Other circuits, however, have disagreed with this *de minimis* rule and count every claim. *In re Okamoto*, 491 F.2d 496, 498 (9th Cir. 1974); *Matter of Rassi*, 701 F.2d 627, 632 (7th Cir. 1983).

E. Number of Petitioning Creditors Required

As discussed above, the number of claim holders determines the number or petitioning creditors required. Where there are fewer than 12 claim holders , one holder of an unsecured claim of at least $13,475 that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount may commence an involuntary petition. Where there are more than 12 claim holders, then three or more entities holding in the aggregate unsecured claims of at least $13,475 that are not contingent as to liability or the subject of a bona fide dispute as to liability or amount may initiate a case. Bankruptcy Code § 303(b)(1). If the dollar test can be met by one unsecured creditor, the numerical requirement of three creditors can be filled by joinder in the petition of fully secured creditors. *Paradise Hotel Corp. v. Bank of Nova Scotia,* 842 F.2d 47 (3d Cir. 1988); *In re Everett,* 178 B.R. 132 (Bankr. N.D. Ohio 1994). A narrow special circumstances exception is recognized, that allows one creditor to initiate an involuntary when three would normally be required, when the alleged debtor has engaged in fraud, trick, artifice or scam by an alleged debtor. *In re Smith*, 415 B.R. at 238; *In re Moss*, 249 B.R. 424.

Although this process appears simple, in practice it can be difficult to determine whether a claim in contingent or subject to a bona fide dispute. The risk of misjudging the number of creditors required to file is ameliorated somewhat by the fact that creditors may join the petition after it is filed, unless the case is found to be filed in bad faith. However, a single filing creditor bears the burden of establishing that the debtor had fewer than 12 creditors. *Atlas Mach.& Iron Works. Inc. v. Bethlehem Steel Corp*., 986 F.2d 709 (4th Cir. 1993).

Furthermore, bankruptcy courts may dismiss a case on the grounds that it presents what is essentially a two-party dispute. *In re Shead*, No. Civ. A. No. H-08-1386, 2008 WL 1995373, at *3 (S.D. Tex. May 6, 2008). The reasons for limiting access to the bankruptcy court lie first in the fact that a dispute with a single creditor generally does not prove that a debtor is not paying its debts as they come due, as required by § 303(h). *See In re Axl Indus., Inc.*, 127 B.R. 482, 484 (S.D. Fla. 1991)); *In re Nordbrock*, 52 B.R. 370, 372 (Bankr. D. Neb. 1984), *aff'd*, 772 F.2d 397 (8th Cir. 1985). Courts also rely on the general policy consideration in that the Bankruptcy Code is designed to benefit classes of creditors rather than a particular creditor. *In re 7H Land & Cattle Co.*, 6 B.R. 29, 32 (Bankr. D. Nev. 1980). An involuntary petition may also be denied if the petitioning creditors possess adequate legal remedies under state law. *In re Kass*, 114 B.R. 308, 309 (Bankr. S.D. Fla. 1990).

F. Eligibility to Act as a Petitioning Creditor

Although §101(5) includes within the definition of claim a broad range of parties to whom an alleged Debtor is currently or potentially liable, a number of significant restrictions are placed upon a claim holder in order to determine their eligibility to petition the court for the institution of an involuntary. The first significant barrier provides that the claim cannot be contingent. This provision essentially requires that the claim cannot depend the occurrence of some future event. Thus, where a borrower has defaulted and the lender has an immediately cognizable action against the guarantor, a debt is not contingent. The mere existence of contested litigation does not render a debt contingent. *Liberty Tool & Mfg. V. Vortex Fishing Sys., Inc. (In re Vortex Fishing Sys., Inc.)*, 277 F.3d 1057, 1064 (9th Cir. 2002).

The second significant bar to obtaining status as a petitioning creditor is the requirement that the claim of a petitioning creditor may not be subject to a bona fide dispute. Although this is a critical issue in determining the ability of a creditor to bring an involuntary proceeding, the Bankruptcy Code does not define this term, and case law on the issue is convoluted. The Fifth Circuit has adopted an objective standard. Specifically, the court must determine whether there is an objective basis for either a factual or a legal dispute as to the validity of the debt. *Subway Equip. Leasing Corp. v. Sims (In re Sims)*, 994 F.2d 210, 220-21 (5th Cir. 1993). If there are substantial factual and legal questions bearing upon the alleged debtor's liability, a bona fide dispute exists and the creditor's claim cannot support the filing of an involuntary case. A non-exclusive list of debts which are not the subject of bona fide dispute includes:

1) the possibility that the amount owed could be adjusted. *In re Focus Media, Inc.*, 378 F.3d 916, 925 (9th Cir. 2004), *cert. denied*, 544 U.S. 968 (2005)(but see § 303(b)(1) by which BAPCPA added a provision that a claim would be excluded if subject to a *bona fide* dispute as to liability or amount);

2) The mere existence of pending litigation. *Liberty Tool & Mfg. V. Vortex Fishing Sys., Inc. (In re Vortex Fishing Sys., Inc.*), 277 F.3d 1057, 1064 (9th Cir. 2002);

3) the mere assertion of a statute of limitations defense unless it clearly establishes that the claim is barred. *Bartmann v. Maverick Tube Corp.*, 853 F.2d 1540, 1543-44 (10th Cir. 1988);

4) the assertion of a counterclaim unrelated to the debt that is the basis for filing the involuntary petition. *Vortex Fishing*, 277 F.3d at 1065; *In re BDC 56 LLC*, 330 F.3d 111, 120 (2d. Cir. 2003).

The U.S. Trustee may always act as a petitioner. As a practical matter, this is unlikely.

G. Proving the Debtor is Not General Paying its Debts

The principal issue to be established in order to obtain entry of an order for relief is set forth in §303(h)(1) and provides that the court will determine the issue of whether the alleged debtor is "generally not paying its debts as such debts become due unless such debts are the subject of a bona fide dispute." The standard for determining the existence of a bona fide dispute in this context is the same as in determining whether a creditor is eligible to petition for an involuntary.

As with determining the issue of the existence of a bona fide dispute, no concrete rule has developed for determining whether debts are not being generally paid as they become due. However, courts generally appear to exercise a flexible standard in light of the total circumstances including consideration of the following:

1. The amount of the unpaid debt in comparison to the total aggregate debt or Debtor;

2. The ratio of unpaid to accruing debts;

3. The existence of a good faith dispute with respect to those debts remaining unpaid;

4. The number and amount of defaults and the context of Debtor's overall handling of its affairs; and

5. The alleged debtor's general payment practices.

See *In re Smith*, 415 B.R. 222 (Bankr. N.D. Tex. 2009); *In re Moss*, 249 B.R. 411, 422 (Bankr. N.D. Tex. 2000).

V. First Day Motions

The first set of issues to arise in a reorganization case will not directly affect contractors or suppliers. Where the filing has been planned in advance, as will generally be the case in any but the smallest cases, the petition is quickly followed by the filing and rapid presentation to the court of "first day" motions. First day motions relate to matters requiring immediate action to continue the debtor's normal business operations during the early phase of a Chapter 11 case. (First day motions are not necessary in a Chapter 7 case as there will be no further business operations). Many courts, and all of the Texas bankruptcy courts, have standardized this process in the context of larger cases by developing complex case procedures that can be found on each court's web site. Many first day motions relate to case management and are not particularly controversial. Such non-controversial motions may include requests for orders:

1. Directing Joint Administration of Related Bankruptcy Cases;

2. Establishing Notice and Administrative Procedures;

3. Extending Time to File Schedules and Statements of Financial Affairs;

4. Seeking Employment of and Interim Compensation Procedures for Professionals;

5. Authorizing Continued Use of Existing Cash Management System, Bank Accounts and Business Forms (Necessary in order to deviate from the general rules promulgated in the U.S. Trustee's guidelines);

6. Authorizing Payment of Pre-Petition Employee Benefits and Pay Pre-Petition Priority Wage Claims (which otherwise are subject to caps provided under §§ 507(a)(3) and (4) and may not be paid quickly enough to retain workforce);

7. Authorizing Continuation of Customer Programs and Payment of Certain Pre-Petition Claims in the Ordinary Course of Business;

8. Permitting the Debtor to Honor Workers' Compensation Programs and Pay Insurance Obligations (Generally, there are few objections to continuing the debtor's workers compensation program and insurance policies. Indeed, federal and state laws, in addition to the U.S. trustee's guidelines require the debtor to maintain certain insurance programs);

9. Establishing Adequate Assurance of Payment for Utilities;

10. Authorizing Payment of Sales and Use Taxes (To the extent the debtor has collected sales and use taxes, such funds may constitute "trust funds" held for payment to the taxing authorities and are not property of the estate. *In re Avant*, 110 B.R. 264 (Bankr. W.D. Tex. 1989) ("the Texas sales-use tax is a trust-fund tax");

11. Administratively Consolidate Related Cases (as distinguished from substantive consolidation which requires a much more stringent set of requirements than can usually be met);

12. Establish procedures for providing and limiting access to sensitive debtor information or filing documents under seal; and

15. Establishing Reclamation Procedures.

Any aspect of the case or the debtor's operations could be the subject of a first day motion, and the items on the list are not necessarily presented on the first day. No rules restrict the type or scope of first day motions if the matter presented could be helpful to the case and does not involve possible overreaching that will damage the debtor's credibility with the court. However, judges have begun to express their concern that first day motions are overused, and do not allow sufficient time for creditor input into the decisions. This is particularly true as to motions that may more substantively affect the direction of the case.

VI. Early Opportunities to Gather Information

A. An Early Look at Case Direction

At risk of stating the obvious, debtors need money, and what money a debtor has is usually subject to someone's security interest. The debtor's effort to gain access to money takes place in the context of motions to use cash collateral (under § 363) and motions to authorize post-petition financing (under § 364). Cash collateral and financing motions may be presented separately at different times, or concurrently. If not presented as first day motions, they will follow the filing of the case fairly quickly. It is not uncommon for these motions to be presented before the filing of the debtor's schedules of assets and liabilities and statement of financial affairs, which are the primary documents disclosing the state of the debtor as of the filing of the case.

At this early stage in the case, contractors and suppliers are essentially observers of maneuvering between the debtor, pre-petition lenders, and post-petition lenders. However, the process whereby the court considers and authorizes the debtor's access to funding, and the information provided during that process, will provide early clues as to the direction of the case, and will be a factor in determining whether the debtor will have money to pay for post-petition operations. Whether required by local rule, or the affected creditors, a request to use cash collateral will virtually always be accompanied by a budget outlining the debtor's planned use of the affected funds. The court's local rules or standing orders may require the provision of additional information about the debtor's early plans for the case. (See Northern District of

Texas General Order No. 00-7 adopting checklist for cash collateral and post-petition financing motions). Thus, contractors and suppliers may be able to gather information regarding the availability of money for use by the debtor in purchasing goods and services during the case.

Cash collateral and financing issues may also be negotiated prior to the filing of a case. Such early agreement might have once been evidence that the pre-petition lenders and debtor were pursuing a "pre-packaged" plan which would lead to a quick reorganization. Now, it may be an indicator that the debtor's assets are going to be quickly sold, which may not be good news for contractors and suppliers. Regardless, these proceedings provide a window into early expectations for how the case will proceed. Resolution of financing issues may include allocation of funds to specific purposes related to administration of the estate. Such allocations, called "carve outs," establish conditions under which funds subject to a secured creditor's interest, or provided by a post-petition lender, are used to pay costs associated with the case which do not directly benefit the creditor or lender. These carve outs will often have conditions attached to them, which indicate areas of concern to the party whose money is being used, which in turn indicate areas for scrutiny by unsecured and lien creditors later in the case. Finally, the debtor's financial disclosure documents, the schedules of assets and liabilities and the statement of financial affairs may provide information about the debtor's status and future prospects. These areas are discussed in more detail below.

B. Cash Collateral Motions

1. Scope of Cash Collateral

Section 363(a) defines "cash collateral" as "cash, negotiable instruments, documents of title, securities, deposit accounts or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest." Most particularly, the debtor's collected receivables are within the scope of cash collateral, thus effectively encompassing all of the debtor's post-petition cash flow. Sections 363(c)(2)(A) and (B) prohibit use of cash collateral subject to a security interest without court approval or permission of each creditor having an interest in such collateral. Using cash collateral without authorization is a fast track to dismissal or conversion to Chapter 7. Rarely does a debtor have free cash and receivables that are not subject to a security interest. Consequently, the debtor, sometimes accompanied by a lender, will request authority to use cash collateral almost simultaneously with the filing of the case and this is usually the first substantive motion presented to the Court.

2. Procedure

The Bankruptcy Code and Bankruptcy Rules set forth the procedures for seeking approval of the use of cash collateral. (§ 363(c)(2) and Bankruptcy Rule 4001(b)). In addition, the local rules for the bankruptcy court where a case is filed will likely have their own specific procedural requirements that must be met. (Northern District of Texas- Local Rule 4001 and Attorney Checklist (for the Northern District) Concerning Motions and Orders Pertaining to Use of Cash Collateral and Post-Petition Financing (Which Are In Excess of Ten (10) Pages)). Bankruptcy Rule 4001(b) recognizes the importance of allowing use of cash collateral in that it authorizes a preliminary decision on limited and shortened notice. However, a final decision requires 14 days notice to interested parties. Bankruptcy Rule 4001. Since cash collateral can vanish quickly, creditors with an interest in cash collateral are not advised to wait for the debtor to ask permission if such a request has not been made quickly, and should seek an order restricting use.

3. Statutory Conditions for Use of Cash Collateral-Adequate Protection

The court may authorize a debtor to use cash collateral over the objection of a creditor having an interest in the collateral only where the requirements of § 363(c)(2) are meet. Most notable among these requirements is that the creditor whose collateral is being use be "adequately protected." The term adequate protection is used in the Bankruptcy Code at several points relating generally to the protection of an existing interest in the case from erosion (§ 362-modification of the stay; § 363- cash collateral, and § 364-post petition financing). To the extent that use, sale, lease or grant of a lien results in a decrease in the value of property subject to a non-debtor's interests, Section 361 defines "adequate protection" as including:

a) one or more cash payments;
b) additional or replacement liens; and
c) such other relief as will "result in the realization by such entity of the indubitable equivalent of such entity's interest in such property"(excluding the grant of an administrative expense priority.

The idea behind adequate protection is to preserve the status quo with respect to the creditor's interest in affected property. Factors that are considered are:

a) whether a claim is oversecured or undersecured;
b) the reasonable expectations of the parties;
c) the nature and quality of the collateral;
d) the duration of the automatic stay;
e) stability of collateral value;
f) the payment obligations to insure collateral and to keep collateral free from statutory liens; and
g) the prospects for successful rehabilitation of the debtor in possession

Memphis-Shelby County Airport Auth. v. *Braniff Airways, Inc. (In re Braniff Airways, Inc.),* 783 F.2d 1283, 1286 (5th Cir. 1986). Adequate protection is intended to preserve the value of the non-debtor's interest from erosion; it does not include lost opportunity costs. *In re United Savings Association of Texas v. Timbers of Inwood Forest Association, Ltd.*, 484 U.S. 365 (1988). Valuation of the property may therefore be a significant element of cash collateral litigation. This was certainly the case in the late 1980's and early 1990's, when much of the fight over adequate protection focused on whether the non-debtor's interest in property being used or subjected to a lien was protected by an equity cushion (the indubitable equivalent of such entity's interest in such property.) These is currently unlikely to be much argument about equity cushions during an bankruptcy taking place in the near future. Therefore, debtors will likely have to put up additional collateral, or make increasing creative arguments as to why adequate protection is present, unless the affected non-debtor consents.

C. Debtor-in-Possession Financing

1. Conditions for Authorization of Post Petition Financing

The debtor may always obtain unsecured credit in the ordinary course of its business without court approval or prior notice. (§ 364(a)). This type of credit is generally trade credit and is an administrative expense that is ordinarily paid on an ongoing basis just as it would be outside of bankruptcy. (However,

there is no guaranty that the debtor will operate this way and if a supplier or contractor is working for a debtor on this basis, they should be ready to quickly ask the court for allowance and immediate payment of the post-petition debt as administrative claim before a debt of this type grows too large). Beyond this type of post-petition "borrowing " in the ordinary course is debtor-in-possession (or more often "DIP") financing. DIP financing is authorized by §§364(b) and (c), which creates a sort of procedural tower in which each option must be exhausted before the next, more burdensome (at least to existing creditors), level in the process can be reached. These options, in the required order, are:

1. A debtor in possession may incur unsecured debt, allowable as an administrative expense, other than in the ordinary course of business only after notice and a hearing by the bankruptcy court. (§ 364(b)).

2. If the debtor cannot obtain unsecured credit allowable as an administrative expense, the debtor may after notice and a hearing obtain credit allowable as a superpriority administrative expense (which elevates the debt above all other administrative claims and unsecured claims). (§ 364(c)).

3. If unsecured credit is unavailable solely with the protections of superpriority administrative status, the debtor may after notice and a hearing obtain post-petition credit secured by a lien on otherwise unencumbered property or secured by a junior lien. (§ 364(c))

4. In the event the debtor in possession proves unable to obtain unsecured credit, unsecured superpriority credit, or credit secured by a lien on unencumbered property of the estate or a junior lien on encumbered property of the estate, the debtor may obtain credit secured by a "priming" lien if the interest of the secured creditor being primed is adequately protected. The debtor has the burden of proof on adequate protection a debtor. (§ 364(d))

The fight in DIP financing tends to focus on whether less burdensome alternative sources are available and whether the court will authorize financing on the terms sought by the DIP lender. However, as mentioned above, unless the DIP is creative, there may not be many choices for DIP financing. The usual parties are the debtor and the proposed DIP lender on one side, with the existing secured lenders, and at times other creditors, aligned against them.

Other issues presented in the context of DIP financing relate to the specific terms of the financing proposal. Parties offering DIP financing may try to include provisions restricting the debtor's plan of reorganization in some way. An existing creditor may offer to provide DIP financing which includes payment of its pre-petition claims, thereby converting them into more favorably treated post-petition claims. Alternatively, an existing creditor may also offer DIP financing under conditions which cross- collateralize the existing claims with the security granted in connection with the DIP financing. Many such conditions may be unpopular with the court. See Northern District of Texas Complex Cases General Order, p. 34.

Of course, DIP financing is only possible where someone is willing to provide the funds. Counterintuitively, DIP financing has historically been attractive to certain types of lender. *See* Jarrod B. Martin, Kristofor W. Nelson, Eric Rudenberg, and Jonathan Squires, *Freefalling With A Parachute That May Not Open: Debtor-In-Possession Financing in the Wake of the Great Recession*, 63 U. Miami L. Rev. 1205, 1206 (July 2009) (reviewing the history of DIP financing and stating "This history buttresses the claim of University of Texas law professor Jay L. Westbrook that "usually a lot of companies compete to make debtor-in-possession loans."). DIP financing was often arranged prior to the filing of a case. Recently, DIP financing

is less available. *Id* at 1208. Anecdotal sources additionally advise that DIP financing uses regulatory capital and most big institutions have been told in no uncertain terms by regulators to improve their capital positions. As a result, some of the biggest players in DIP financing have left the building, and reorganizations are now harder to finance. As with cash collateral litigation, contractors and suppliers are usually sitting on the sidelines for this contest. However, the ability of the debtor to obtain DIP financing, and the conditions imposed by such financing, may directly affect payments for both prepetition and post-petition services and supplies and contractors and suppliers should be aware of the restrictions that may be placed by the court on debtor's use of funds.

2. Procedure

The provision of post-petition credit is controlled by § 364 and Bankruptcy Rule 4001(b). As with cash collateral, interim relief can be granted on limited and short notice. However, a minimum of 14 days notice is required for a final hearing on a § 364 motion.

3. New Developments

As DIP financing from traditional lenders have become less available, ingenious debtors are looking elsewhere. Recently in a case pending in the Northern District of Texas, the debtor organized certain vendors to provide funding "in kind" in the form of the goods and services needed to complete certain oil and gas well in exchange for payment from net profits of any producing wells. *In re Cornerstone E&P Company, Bankruptcy Case No.*09-35228-bjh-*11* at Docket No 15 - *Emergency Motion for an Order (I)Approving Interim and Final Use of Cash Collateral and Granting Adequate Protection; (II) Granting Authority to Make Payments to Royalty and Working Interest Owners: and (III) Approving Vendor-Financing Agreement*. Chrysler LLC and General Motors obtained DIP financing from the United States of America, and some members of Congress have called for legislation authorizing more general resort to government funds for DIP financing. There is a possibility smaller private lenders may step into the gap left by the exit of large traditional lenders. See Martin, Nelson, Rudenberg, and Squires, *Freefalling With A Parachute That May Not Open: Debtor-In-Possession Financing in the Wake of the Great Recession* at 1211-1212. There is much room for innovation here, and in the upcoming years there may be new sources for DIP financing from unexpected areas.

D. Carve-outs

A notable feature of funding the debtor-in-possession, whether through cash collateral, DIP financing, or both, is the issue of carve-outs. The primary definition of a carve-out when used in a bankruptcy case is the express allocation or set aside (and thus carve out) of cash subject to a creditor's security interest for the purpose of funding some aspect of bankruptcy case administration. Typically a carve-out is made from a secured creditor's collateral to fund payment of fees that will be owed by the estate (through the debtor-in-possession) or an official creditor's committee to their professionals (lawyers, accountants and valuation experts to name a few). *See Costa v. Robotic Vision Sys. (In re Robotic Vision Sys.)*, 367 B.R. 232, 237 n.23 (B.A.P. 1st Cir. 2007); *In re US Flow Corp.*, 332 B.R. 792, 796 (W.D. Mich. 2005) ("[A] carve-out is a portion of post-petition loan proceeds that is reserved specifically to pay attorneys and other professionals of a DIP."). The carve out is intended to guarantee that a lien or super-priority will not reach certain funds, usually up to a maximum dollar amount, in order that professional fees can be paid. *Robotic Vision*, 367 B.R. at 237 n.23.

The incentive for the affected lender is sometimes hard to discern, but it has become almost

customary in larger cases, and thus expected by the courts. There are two main reasons. The first is that the lender offering the carve out is getting something in the form of the bankruptcy protections afforded its cash, and must in return provide for the costs of a chapter 11 proceeding. This theory particularly applies if the case ends in a § 363 sale. The second reason the lender may allow it is as the purchase price for something the lender wants, such as a release or waiver of some deficiency. Courts guard to some extent against overreaching, but generally only if someone complains. The trend appears to be to provide one carve-out for both the debtor's professionals and the committee's professionals. Contractors and suppliers should look for restrictions on the carve-out, as the lender providing the funds may undertake to discourage certain activities by carving them out of the carve-out.

E. The Schedules and Statements of Financial Affairs

Section 521 requires that the debtor file certain basic financial information early in the case. Bankruptcy Rule 1007(c) (amended as of December 1, 2009) requires the debtor to file this information within 14 days of the filing of the case unless the court extends the time. The basic information required is:

1) a list of creditors;
2) a list of assets and liabilities (the "Schedules");
3) a list of current income and expenditures; and
4) a statement of the debtor's financial affairs (the "SOFA").

These schedules can contain significant information about the pre-bankruptcy transactions of the debtor. In particular, they may reveal whether the debtor intends to contest a creditor's claim. As will be discussed further below, they can be the key to application of the doctrine of judicial estoppel if a debtor later seeks to file a lawsuit on an unlisted cause of action against a creditor. In a Chapter 11, if a creditor's claim is listed, and is not marked as unliquidated, contingent or disputed, the creditor is not required to file a proof of claim. See Bankruptcy Rule 3003(c).

VII. Critical Vendor Motions

Critical vendor motions may come before the court as a component of the debtor's "first day" motions, but need not be presented as such. A critical vendor motion is a technique whereby a debtor seeks authority from the court to make early payments to select unsecured creditors who otherwise would not receive payment until confirmation of a plan or distribution of funds upon liquidation, if at all. Simply put, the effect of critical vendor payments is to prefer certain creditors in a way which seems prohibited by the classification and distribution provisions of Chapter 11. Critical vendor motions are based on the premise that the continuation of the delivery of goods and materials by certain creditors is essential to the continued operation of the debtor.

Critical vendors are basically unsecured creditors, and there is no express authority in the Bankruptcy Code authorizing them to be treated differently. *In re CoServ, L.L.C,* 273 B.R. 487, 493 (Bankr. N.D. Tex. 2002). Nevertheless, courts have long authorized preferential treatment of what have become called critical vendors in special circumstances. *See Dudley v. Mealey*, 147 F.2d 268, 271 (2d Cir. 1945) (payments authorized to creditors providing goods or services necessary to hotel operation). Courts justify their use based on the indirect application of two primary doctrines. The first such source is a combination of the Bankruptcy Court's general powers under §105 to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of Title 11 and other provisions of the Bankruptcy Code depending on the type of creditor as to which payment is sought. The provisions relied upon to supplement §105 are most commonly:

1) the court's ability to authorize a debtor to use property of the estate other than in the ordinary course of business (§363);
2) the court's ability to approve the post-petition extension of credit to the debtor (§364); and
3) the court's ability to allow payment of costs of preserving the estate as an administrative expenses (§503).

More recently, supplemental source authority has been found to authorize critical vendor payments under the "doctrine of necessity." The doctrine is derived from the duty of the debtor-in-possession, as the equivalent of a trustee under § 1107(a), to protect the going-concern value of an operating business in a Chapter 11.

Over the past ten years the use of critical vendor motions had surged, and for a time the exception seemed poised to swallow the rule. Concern then developed that critical vendor motions were being overused. *See In re K-Mart Corp.*, 359 F. 3d 866 (7th Cir. 2004)(questioning whether critical vendor motions are really necessary to insure access to materials). Courts warned creditors not to try too hard to be classified as a critical vendor by noting that lobbying for such status might be a wilful, and thus sanctionable, violation of the automatic stay. In addition, a possibility exists that payments made to a critical vendor who really should not have been classified as a critical vendor may be recovered as a preferential transfer. *Id.* (Payments to creditors under critical vendor order are not protected from later recovery).

In the last few years, the use of critical vendor motions appears to have been broadly accepted. Although differing standards have been used during this evolution, and still remain, harmony seems to be developing, particularly in Texas. In the Northern District, Judge Michael Lynn's decision in *In re CoServ, L.L.C.* appears to be moving toward becoming the established the standard. Judge Lynn stated:

> The debtor must show three elements are present. First, it must be critical that the debtor deal with the claimant. Second, unless it deals with the claimant, the debtor risks the probability of harm, or, alternatively, loss of economic advantage to the estate or the debtor's going concern value, which is disproportionate to the amount of the claimant's prepetition claim. Third, there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim. If these three conditions are proven by a preponderance of the evidence, necessity of payment has been shown, and this Court will authorize payment of the prepetition claim.

Id. at 498. *See also In re CEI Roofing, Inc.,* 315 B.R. 50, 59 (Bankr. N.D. Tex. 2004)(considering both approaches and concluding that the *CoServ* test should be used as the standard against which to measure the debtor's entitlement to relief under either theory).

Not only have critical vendor motions become part of the landscape, but they may be starting a new period of growth in ways that can have repercussions later in the case. Recently, in a bankruptcy of a supplier to Chrysler LLC, a critical vendor motion was used as a tool to partially discharge unsecured vendor debt, and avoid the need to cure defaults in executory contracts with vendors. In *In re Mark IV Industries, Inc.*, Bankruptcy Case No. 09-12795 pending in the Southern District of New York, the debtor filed a motion asking the court to authorize the payment of pre-petition claims of critical vendors up to a total amount. The debtor also asked that it be allowed to identify the vendors in the ordinary course of business, rather than in the motion, and to enter into separate agreements at the Debtors' discretion with each such critical

vendor on a case-by-case basis. (Ostensibly to avoid giving the critical vendor designate any advantages over the debtor.) The debtor proposed a general term letter which could be modified by filing in the blanks, and attached the form of the letter to the Motion.

The Court approved the cap payment, the letter and the procedures. The letter, however, went much further than just confirming the terms of the payment to the creditor. In particular, in exchange for receiving an agreed portion of pre-petition amounts owed to the "critical vendor," such vendor agreed:

1) to continue to supply goods and services to the Debtor based on terms defined by the debtor as those most favorable to the debtor in effect prior to the petition;
2) waived the remainder of its pre-petition claim;
3) waive its right to demand cure payments with respect to the assumption of any executory contract in effect between the parties;
4) provide a new post-petition credit line;
5) allow a payout over time of administrative expenses after confirmation of the plan;
6) waiver of reclamation claims; and
7) consent to recovery of the funds if the Critical Vendor Payment Program or the critical vendors participation terminated, or the critical vendor later refused to continue to supply goods to the Company on Customary Trade.

Amazingly enough, most of the critical vendors appear to have agreed to these terms to get paid a portion of their claim immediately.

Going forward, being selected as a critical vendor may in fact be an invitation to a dinner party where your client gets stuck with the bill rather than a good opportunity to get paid. Critical vendor motions and their attachments should be carefully reviewed to see what they really do, and then the creditor's position in the case must be compared with the proposed treatment to see which is better. In many cases, if a creditor is a party to an executory contract, it may be wise to decline the opportunity to be designated a critical vendor even if work continues to be performed or material provided as such post-petition debt is an administrative expense, and the creditor may be treated better in connection with the disposition of any executory contract it might be able to assert.

VIII. Presenting a Claim

A. The Meaning of Claim

As discussed above in the context of involuntary cases, a claim is defined by §101(5) as a right to payment or an equitable remedy for breach of performance, regardless of whether such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. A claim is eligible to participate in distributions from the bankruptcy estate once it is allowed.

B. Time for Presenting a Claim

The time to file a claim in a Chapter 7, Chapter 12 and a Chapter 13 case is set by Bankruptcy Rule 3002(c) as the date 90 days after the first date for which the creditor's meeting under §341(a) is set. (Rescheduling of the meeting of creditors will *not* change this deadline without further notice or order). Usually, *but not always,* this claims bar date will appear in the initial notice sent out by the Court Clerk advising persons on the debtor's list of creditors that the case has been filed. The initial notice may also

direct that creditors should not file claims until further notice in a Chapter 7 case filed with the indication in the petition that there are no assets available for distribution. If the notice contains an instruction not to file a claim, and assets are discovered, a later notice will be sent out setting a bar date. Bankruptcy rule 3002(c)(5). Bankruptcy Rule 2002(a)(7) requires that all creditors be given not less than 21 days notice by mail of the time fixed for filing a proof of claim.

In most Chapter 11 cases, the claims bar date is set by Court Order, although it may be automatically set and noticed by a court's local rule. Deadlines for presenting administrative claims and claims arising from the rejection of an executory contract are not included within the rules relating to other claims. Instead, the time and procedures for presenting such claims are determined by order of the court, or in connection with the confirmation of the plan of reorganization. Bankruptcy Rule 3003(c)(4). Bankruptcy Rule 3003(c) also authorizes a non-standard filing under certain other circumstances. However, creditors may be omitted by mistake or intent of the debtor, so once a creditor gets wind of a filing, the claims bar date should be checked immediately.

Rule 3003(c) authorizes filing claims after the passage of the bar date under limited circumstances and provides that notwithstanding expiration of the bar date, a proof of claim may be filed under the conditions set forth in Rule 3002(c)(2), (c)(3), (c)(4), and (c)(6) (rules pertaining to infants/incompetents, judgment creditors, claims for rejection damages, and claims by creditors with a foreign address, respectively). A claim that is late because the debtor did not provide timely notice of the case is subject to different rules as a result of federal due process concerns and allowed if it is filed prior to a distribution in a Chapter 7. (§Code 726(a)(2)(c)). Unless an exception is available, a late-filed proof of claim may still participate in the bankruptcy proceeding. However it will be subordinate to the claims of all other unsecured creditors who filed timely proofs of claim or were properly scheduled. See § 726(a)(3). Thus, as a practical matter it is highly unlikely that a late-filed claimant will receive any payment.

A narrow exception is available by which a late filed claim may be granted equal status with timely filed claims in a Chapter 11 case. See Bankruptcy Rule 9006(b)(1); *Pioneer Investment Services Co. v. Brunswick Assoc. Ltd.*, 113 S.Ct. 1489 (1993). This exception is essentially available only where the creditor's attorney establishes that the late filing is the result of excusable neglect. The exception is not available in cases under Chapter 7 and 12. *In re Jones,* 154 B.R. 816 (Bankr.M.D. Ga. 1993). In a Chapter 13 case, a late filed claim may be allowed if no party in interest objects. *In re McLarry*, 273 B.R. 753 (Bankr. S.D. Tex. 2002); *In re Miranda*, 269 B.R. 737 (Bankr. S.D. Tex. 2001).

C. Procedure for Presenting a Claim

A claim is presented by means of filing a proof of claim, which is "a written statement setting forth a creditor's claim." Bankruptcy Rule 3001(a). The standard form for a proof of claim is set by Official Form B-11. The claim is generally filed with the clerk for the district where the case is pending (which is now likely to be means of electronic filing.) Increasingly in Chapter 11, non-standard procedures for presentation of basic claims are being established at the debtor's request by court order. These non-standard procedures typically appear in large cases where the debtor has contracted out to a third party service company aspects of the bankruptcy case administration process. However, in a case where the court has entered non-standard claims procedures, *they must be followed to the letter or a claim will not be allowed*. See *In re MarchFIRST, Inc.,* 573 F.3d. 414 (7th Cir 2009) (strictly enforcing the court's order directing the filing of claims with a claims agent by mail or hand delivery by a specified time). A claim may also be filed by the debtor, trustee or entity that is liable with the debtor on a claim on behalf of creditors who fail to file a proof of claim. See § 501(c) and Bankruptcy Rules 3004 and 3005. However, such claim can only be filed during a 30-day window following the bar date for the creditor.

In some cases, a claim may not be required. In Chapter 11 case, Bankruptcy Rule 3003 provides that if the Debtor has scheduled a creditor's claim without marking it as unliquidated, contingent or disputed, a creditor is required to file a claim only if the if creditor disagrees with the manner in which the debtor has scheduled the claim. However, the treatment afforded the claim can change during the course of the case if the debtor amends its schedules, and any change might go unnoticed in cases where the schedules can be hundreds of pages. If a creditor is secured, it does not need to file a claim to preserve its lien, although failing to do so will result in the loss of any deficiency claim.

Filing a claim is almost always advisable. However, there are specific circumstances when it may not be because filing a claim subjects the creditor to the jurisdiction of the court. By consenting to such jurisdiction, a creditor may waive certain rights (including the right to jury trial). Other strange results may follow. A good example of the wrong decision on whether to file a claim is presented by Pierce Marshall's actions in the Vicki Lynn Marshall (otherwise known as Anna Nicole Smith) bankruptcy case. By filing a claim in Vicki Marshall's bankruptcy case, Pierce Marshall subjected himself to bankruptcy court jurisdiction, allowing Vicki Marshall to object to the claim and assert a counterclaim challenging the debt. Thus, while Pierce Marshall won a judgment in a Texas probate court, the result in the bankruptcy adversary went badly against him in a fight he might have avoided by not filing a claim.

D. Priorities

The Bankruptcy Code groups claims into categories, and establishes a scheme prioritizing the distribution of the debtor's assets to those categories. This system is designed for the distribution of the proceeds of the liquidation of the debtor's assets that takes place in a Chapter 7, but the hierarchy of priorities also affects the rights of the claim holders in other chapters. In the broadest sense, claims accruing, either in fact or by operation of law, prior to the date on which the petition is filed are essentially categorized by their status under state law. Thus, claims are either secured, partially secured (undersecured), or unsecured. An additional layer of claims is added purely by operation of bankruptcy law. These are administrative claims accruing after the date on which a petition is filed and which relate to the operation of the bankruptcy estate. § 503. Examples of administrative claims include post-petition rent, creditor committee expenses, professional fees, and utility bills. However, a debt incurred for routine trade purchases after the date of the petition is typically also an administrative claim. To be granted administrative status, a claim must actually benefit or contribute to the bankruptcy estate. However, as discussed in more detail below, Bankruptcy Code § 503(9) statutorily defines claims for goods delivered in the 20 days before petition date as administrative.

Secured claims are at the top of the food chain in bankruptcy and their treatment is discussed primarily in relation to the provisions of § 506. However, secured creditors are not really part of the overall priority system as their interests derive from the Bankruptcy Code's recognition of the contractual (or in some cases statutory) system that grants them a superior claim to their collateral. If a secured creditor's claim exceeds the value of the property, the excess portion of the claim (the "undersecured" amount) is simply an unsecured claim (subject to something called the Section 1111(b) election, which is not applicable to construction or supplier creditors and is beyond the scope of this presentation). Subject to the overarching rights of secured claims, the Bankruptcy Code establishes the following rank for allowed claims of other types:

1. Super priority claims allowed by the Bankruptcy Court during the bankruptcy case for new credit extended to the debtor during the bankruptcy or arising from a loss experienced because "adequate assurance" was inadequate (see Section VI.C.1. above) (§ 507(b)). These

may also be give rights as secured creditors;

2. Allowed unsecured claims for domestic support obligations (§ 507(a)(1));
3. Administrative expenses of the estate allowed under Bankruptcy Code § 503 (§ 507(a)(2)):
4. Unsecured claims arising during the involuntary gap allowed under Bankruptcy Code § 502(f) (§ 507(a)(3));
5. Unpaid wages and commissions, up to $10,950 for each individual, earned during earlier of the 180 days before bankruptcy or the cessation of debtor's business (§ 507(a)(4));
6. Contributions to an employees' benefits plan, up to $10,950 per employee, less the amount paid on wage claims under Bankruptcy Code § 507(a)(4) (§ 507(a)(5));
7. Claims against a grain storage facility or fish produce storage or processing facility for grain or fish deposited into the facility, up to $5,400 per claim (§ 507(a)(6));
8. Layaway purchases, up to $2,425 (§ 507(a)(7));
9. Taxes owed to governmental entities as of the petition date that are not secured by tax liens, (tax liens are secured claims), (but if not paid in bankruptcy are also nondischargeable if less than 3 years old) (§ 507(a)(8));
10. Unsecured claims. (§ 726(a)(2)) (Discussing liquidation distribution in a Chapter 7); and
12. Ownership interests in the debtor.

Claims with higher priority get paid in full before any payment can be made for lower priority claims (or claims without any priority)(subject to variations included within a plan or reorganization). When claims are of equal priority and funds are insufficient to satisfy all of them fully, they share pro rata. The debtor must adhere to this priority schedules in developing any plan of reorganization in Chapters 11. This requirement is known as the "Absolute Priority Rule" and is probably the unsecured debtor's most effective weapon in dealing with the development if a reorganization plan as the debtor seeking to retain an existing ownership structure can confirm a plan violating the absolute priority rule only if the affected class of creditors approves the plan.

E. The Informal Claim

Usually a claim must be presented in the manner and method prescribed by the Bankruptcy Code or a court order altering the Code's procedures. However, since Bankruptcy Rule 3001(a) provides that a claim is presented by means of "a written statement setting forth a creditor's claim," but does not prescribed a specific form of "written statement,"a savings doctrine has developed to preserve the claim of a creditor who may have participated in the case but failed to file a claim. This doctrine recognizes the "informal" filing of a claim under narrow circumstances.

The standards applied by virtually all courts (with some variation in language or description) in determining the presence of an informal proof of claim are:

(a) the claim must be in writing;
(b) the writing must contain a demand by the creditor on the debtor's estate;
(c) the writing must evidence an intent to hold the debtor liable for such debt;
(d) the writing must be filed with the bankruptcy court; and
(e) based upon the facts of the case, allowance of the claim must be equitable under the circumstances.

See In re Nikoloutsos, 199 F.3d 233 (5th Cir. 2000) (quoting *Reliance Equities, Inc*., 966 F.2d 1338, 1345 (10th Cir.1992). These requirements are regarded as merely broad general guidelines and not all elements are always necessary. *See In re Haugen Construction Services, Inc.,* 876 F.2d 681, 682 (8th Cir.1989) (holding that

the document alleged as the informal proof of claim need not be filed with the Court.) Using these parameters, courts have construed a variety of documents as informal proofs of claim including:

(a) motions for relief from an automatic stay. *In re Pizza of Hawaii, Inc.,* 761 F.2d 1374 (9th Cir.1985); *In re Guardian Mortgage Investors,* 15 B.R. 284 (Bankr. M.D. Fla.1981);

(b) letters notifying the trustee of a debt of the estate, *In re Anderson-Walker Industries, Inc.,* 798 F.2d 1285, 1288 (9th Cir.1986); and

(c) complaints against a chapter 7 discharge together with an objection to a chapter 13 plan. *In the Matter of Scott,* 67 B.R. 1011 (Bankr. M.D. Fla.1986).

Since by its nature an informal proof of claim is not included on the register of claims for the case, it is necessary to take some other action in the court to recognize the informal claim. Such action could include a request to amend the claim, which will bring it to the attention of the debtor and the court. Alternatively, a motion seeking allowance of the claim could be filed. Once established, an informal proof of claim is effective to the same extent as a claim presented through established channels. However, assertion of an informal claim is never something a creditor or its counsel should set out to do.

F. Amendment of Claim After Filing

Once a claim is filed, it can be amended to adjust the amount stated in the claim. *Highlands Ins. Co. v. Alliance Operating Corp. (In re Alliance Operating Corp.),* 60 F.3d 1174, 1175 (5th Cir. 1995); *In re Kolstad,* 928 F.2d 171, 175 (5th Cir. 1991); *United States v. Johnston,* 267 B.R. 717 (N.D. Tex. 2001). However, once the bar date has passed, an amendment may not state wholly new grounds of liability. *In re Alliance Operating Corp.,* 60 F.3d at 1175; *In re Kolstad,* 928 F.2d at 175. Further, the character of the claim may not be changed by amendment. *In re Alliance Operating Corp.,* 60 F.3d at 1175 (denying amendment changing claim from unsecured claim to priority).

G. Recognition (Allowance) of the Claim and Claims Litigation

The first step in the claim process is having the court allow it. In the absence of an objection to a claim, a claim is allowed. (§ 502). Bankruptcy Rule 3007 dictates the procedures for objecting to a proof of claim. These procedures may also be supplemented by the court's local rules. A proof of claim is *prima facie* evidence of the claim against the debtor and the debtor must establish sufficient, credible facts to shift the burden of proof. *In re Simmons*, 765 F.2d 547, 551-552 (5th Cir. 1985); Bankruptcy Rule 3001(f). The filing of an objection initiates a contested matter under Bankruptcy Rule 9014. However, if the objection to a claim includes a counterclaim seeking relief that can only be granted in an adversary proceeding, as defined by Bankruptcy Rule 7001, then the objection must be prosecuted as an adversary proceeding.

Notwithstanding the viability of a claim under non-bankruptcy law, certain types of claims are limited or disallowed under § 502(b):

a. most claims for unmatured interest;
b. property tax assessments in excess of the value of property;
c. "unreasonable" claims by insiders or debtor's attorney;
d. unmatured, nondischargeable claims for family support;
e. claims arising from the rejection of a real property lease is allowable only for the

greater of rent for one year or 15% of rent due under the remaining term of lease not to exceed 3 years;

f. claims not filed in a timely manner;

g. claims of entities liable to the debtor for an avoidance action who have not returned or repaid the obligation;

h. claims arising from the rejection of an employment contract.

Resolution of claims objections may not be completed, or even begun, at the time voting on a plan is required. It is the court's duty to value or estimate any contingent or unliquidated claims, or claims for equitable relief arising from a breach of contact, when plan confirmation is likely to occur before the claim can be liquidated.

Procedurally, objections are handled differently depending on the Chapter under which the case is filed. Bankruptcy Rule 3007 establishes no deadlines by which an objection must be filed. Typically, in a Chapter 7, objections are filed by the Chapter 7 Trustee in connection with the administration of the estate, and prior to payment of any distributions. In a Chapter 13, objections may come from the debtor, or the Chapter 13 trustee. In a Chapter 11, objections may not be filed until after a plan is confirmed, and are initiated typically by the reorganized debtor in connection with implementation of the plan, but may be initiated by a successor entity. Objections in a Chapter 7 and a 13 are may be made one at a time or or collectively in fairly small groups. Objections in a Chapter 11 case are typically made by means of an "omnibus" format, whereby form objections are lodged to numerous claims by means of elaborate charts that may be several hundred pages long in a large case. It is therefore necessary to carefully look at these omnibus objections to even determine if a creditor is subject to the objection. Because they are unwieldy, omnibus objections are specifically restricted by provisions of Bankruptcy Rule 3007. Regardless of these rules, omnibus objections are commonly used, and an objection to the format is not likely worth the effort.

The procedures related to objections to administrative claims are essentially inverted in that the claimant must initiate the process by requesting allowance of the claim, with objections lodged as responses. Claims of professionals are processed under different rules relating to the circumstances of their employment.

H. Estimation

Since claims may not be fully liquidated until later in a case, the court may need to estimate the value of a claim. This is particularly true in Chapter 11 cases where the creditors may be called upon to vote on a plan prior to the decision on whether to allow the creditors claim. Section 502(c) authorizes the court to estimate the claim. Procedurally, since it is not enumerated as an adversary proceeding, claim estimation is conducted as a contested matter. See also *In re Hoffinger Indus. Inc.,* 307 B.R. 112, 118 (Bankr. E.D. Ark. 2004); *In re FV Steel and Wire Co.,* 372 B.R. 446, 452-53 (Bankr. E.D. Wis. 2007). An estimation proceeding may be commenced by the affected creditor as well as the Trustee of DIP (§502(a)). Bankruptcy courts may use whatever method is best suited to the circumstances to estimated the claim. *In re Brints Cotton Marketing, Inc.,* 737 F.2d 1338, 1341 (5th Cir. 1984).

I. Subordination and Recharacterization

In addition to objection, equitable subordination and recharacterization may be used to reduce the priority rank of a claim. Subordination is governed by § 510(c) and is generally directed at secured creditors in an effort to reduce their rank to unsecured based by transferring their lien to the estate. Equitable subordination is allowed where a claimant: (i) engaged in some type of inequitable conduct; (ii) that resulted

in injury to the creditors of the debtor or conferred an unfair advantage on the claimant; and (iii) equitable subordination of the claim is not inconsistent with the provisions of the Code. *Summit Coffee Co. v. Herby's Foods (In re Herby's Foods)*, 2 F.3d 128 (5th Cir. 1993). Equitable subordination is discretionary with the court. *Bayer Corp. v. Mascotech, Inc. (In re AutoStyle Plastics, Inc.)*, 269 F.3d 726 (6th Cir. 2001); *Farr v. Phase-I Molecular Toxicology, Inc. (In re Phase-I Molecular Toxicology, Inc.)*, 287 B.R. 571 (Bankr. D.N.M. 2001).

Recharacterization is the process by which money advanced to the debtor is changed from a debt owed to a creditor to an infusion of capital from an equity interest holder. A variety of tests have been developed for application of equitable subordination. See *Roth Steel Tube Co. v. C.I.R.*, 800 F.2d 625 (6th Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987); *Sender v. Bronze Group, Ltd. (In re Hedged-Invs. Assocs., Inc.)*, 380 F.3d 1292 (10th Cir. 2004) (citing *Stinnett's Pontiac Serv., Inc. v. C.I.R.*, 730 F.2d 634 (11th Cir. 1984)); *In re Hoffinger Indus., Inc.*, 327 B.R. 389, 394 (Bankr. E.D. Ark. 2005). However, these tests center around the formality of the loan agreement, the circumstances of the debtor at the time the loan was made (i.e was the loan made at a time no one else would take the risk), and the relationship of the creditor and debtor.

IX. Reclamation and Administrative Claim for Goods Delivered Prior to Bankruptcy

A. Creation of Federal Reclamation Right

BAPCPA amended § 546 to provide for a right to reclaim goods sold to the Debtor during the 45 days prior to the commencement of a bankruptcy case if a demand for reclamation is made in writing not later than 45 days after the debtor received the goods. Where the 45-day period expires after a bankruptcy case is commenced, the reclamation period is extended to the 20th day following the commencement of the bankruptcy case. Since the amendment struck the Bankruptcy Code's prior reference to "statutory or common law" reclamation rights, this change essentially creates a uniform federal right of reclamation which, in most cases, is significantly expanded from prior law. However, the amendments to §546 also except from these new reclamation rights the rights of the holder of a security interest in "such goods or the proceeds thereof." Therefore, in most cases material delivered to a customer in the days before they become a debtor in a bankruptcy case will become subject to the customer debtor's secured creditors liens in inventory. Consequently, although the ability to reclaim property should be reviewed, it generally will not be an important feature of most bankruptcy cases. Instead, the debt for the delivered goods will give rise to a new administrative priority claim.

B. Administrative Priority Claim For Goods Received Immediately Prior to Filing.

BAPCPA also amended the Bankruptcy Code to add §503(b)(9) which creates a new administrative priority claim. This claim is for the:

> value of any goods received by the debtor during the 20 days prior to the commencement of a case under this title in which the goods have been sold to the Debtor in the ordinary course of such debtor's business.

The priority is specifically created for the "value" of the goods, and not the sale price. Superficially, the sale price and the value might seem to be the same. However, since Congress used the word "value" instead of "invoice" or "contract price," where large sums are in dispute debtors can be expected to seek to strip the profit from goods subject to this provision, or create other arguments regarding the meaning of the word "value" which avoid reference to the invoice price. Nevertheless, this new provision has significantly improved the position of the seller of goods in many cases.

X. Creditor Committees

A. Basis for Appointment

Section § 1102(a)(1) requires that the United States Trustee for the district in which a case is filed appoint a creditors' committee as "[A]s soon as practicable." Typically, volunteers are solicited from unsecured creditors appearing on the list of 20 largest unsecured creditors filed by the debtor, with the goal of including a representative cross section of the unsecured creditors as a whole. If that is not possible due to conflicts between the interests of kinds of unsecured creditors, the Trustee has discretion to appoint more than one official committee. (§ 1102(a)(1)). The court may also direct the United States Trustee to change the membership if requested by a party in interest in the case. These are rare events. In a "small business case" creditors may request that a committee not be appointed. (§ 1102(a)(3)).

B. Duties of a Committee

The committee is charged with protecting the interests of unsecured creditors as a whole. The Bankruptcy Code sets out the powers and duties of committees. Section 1103(c) specifically provides that a committee may: 1) consult with the trustee concerning the administration of the case; 2) investigate the operation of the debtor's business; 3) participate in the formulation of a plan of reorganization and advise its constituents as to the committee's position on the plan; 4) request the appointment of a trustee or examiner; and 5) perform such "other services as are in the interest of those represented." This is not an exclusive list of a committee's powers and duties. Section 1109 identifies committees as "parties in interest" with a right to raise and appear and be heard on any issue in a bankruptcy case. Typically, in a chapter 11 case, committees are heavily involved in the administration of the case and a committee's acceptance (or rejection) of another party's legal position carries a great deal of weight with the court.

C. Hiring Supporting Professionals

Committees are entitled to, and virtually always will, hire counsel who may be paid as an administrative cost of the case. Thus, if the debtor has cash, it can be compelled to pay the committees' attorneys fees. In a large case, provisions for the payment of the committee's costs and attorneys fees may be made in the cash collateral order or DIP financing, but the terms and conditions of such payment vary widely and are highly negotiable. Competition for committee work is such that law firms are willing to undertake representation of committees without any guaranty of payment by committee members if payment is not made from case-related sources.

D. Decision to Seek or Accept Appointment.

Appointment to the creditors' committee effectively increases the appointed creditor's presence in the bankruptcy process. As such, committee members are likely to receive more information regarding the case, and be regularly involved, or even consulted, by the debtor and other parties formulating a plan of reorganization. Committees may also be proponents of a plan of reorganization under the same timing and conditions authorizing non-debtor's to put forward plans.

However, there are a number of drawbacks. An individual creditor may act in its own interest without restraint. As a committee member, a creditor takes on fiduciary duties to the entire class of creditors that it represents, regardless of whether or not a particular subset actually has a representative on the committee. *See In re Pierce,* 237 B.R. 748, 758 (Bankr. E.D. Call. 1999))*: Mirant Americas Energy Mktg., L.P. v. Enron Corp.*, 2003 U.S.Dist LEXIS 18149 at *15-16 (Bankr. S.D.N.Y. Oct. 10, 2003). Committee

members are entitled to reimbursement of actual expenses incurred in the performance of their duties. (§503(b)(3)(F)). However, they are not entitled to payment for their service on the committee.

XI. Sales Free and Clear of Liens under § 363

A. Current Controversy over the Scope of Bankruptcy Code § 363

Sales conducted under § 363 have been an area of intense attention for several years, and scrutiny has only increased through the use of § 363 in the bankruptcy cases of both Chrysler LLC and General Motors Corporation (where § 363 sales were approved within 45 days of the filing of the bankruptcy). The issue is whether in authorizing the "use, sale or lease" of property, there should be an implied restriction on the quantity of property being sold so that the sale is not really a reorganization taking place without the safeguards required in connection with the confirmation of a plan (referred to as a sub rosa plan as discussed in *In re Braniff Airways Inc.*, 700 F.2d 935 (5th Cir. 1983)). The argument revolves around two main points. Opponents of the sale of all of the assets under § 363 argue, in essence, that such sales are undertaken against the policies embodied in the Bankruptcy Code as a whole, and particularly the procedures enumerated in Chapter 11 as part of the reorganization process. Proponents of Section 363 sales argue that § 363 does not prohibit the sale of all assets, so it must be acceptable.

Despite the *Braniff* court's concern about *sub rosa* plans, a sale of substantially all assets outside of a plan has historically been found permitted under § 363 if a proponent offers a "good business reason" for the sale. *See In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983). Factors the court may consider in authorizing such a sale include whether the property is increasing or decreasing in value, what proportion of the estate is being sold, the prospect that a plan will be filed and confirmed soon, and the time since the petition was filed. From a theoretical perspective, the competing trends manifested by *Braniff* and *Lionel* can perhaps be analytically resolved by regarding *Braniff* as opposing a § 363 sale process with plan-like provisions, whereas *Lionel* just authorized a sale without other conditions attached. However, in practice the line between a permissible sale and an impermissible *sub rosa* plan seems resolved by the judge on a case by case rather than through clear application of a well defined standard. Thus, in one of the grandest uses of § 363 in the history of the Bankruptcy Code, the judge in the General Motors case likened the standard to that oft articulated in the context of pornography, stating "The standard we need to apply to 363 is like Potter Stewart's analysis of pornography: We know it when we see it." See WSJ Blogs, Bankruptcy Beat at http://blogs.wsj.com/bankruptcy/2009/10/05/pornography-and-section-363 (quoting Judge Robert E. Gerber's speech to the American Bankruptcy Institute). Judge Gerber went on to say that judges must be able to use their own discretion in approving so-called 363 sales if they're necessary to save a company from "dying on the operating table." *Id.* Not everyone agrees with a "call-it-like-you-see-it" standard. However, as a practical matter for the present there is case law to support most every alternative, and the party with the best practical argument in the context of the facts of the case will likely win the issue.

B. Procedure

Use, sale or lease estate of property is authorized without court approval if such actions are within the ordinary course of a debtor's business. (Except as restricted by a secured creditor as discussed in the context of cash collateral). What is "ordinary course" turns on what is ordinary in the applicable industry and what is typical for the particular debtor; both elements of the test focus on the reasonable expectations of creditors. However, where an action is not in the ordinary course, notice to creditors and court approval is required. The court may approve a sale outside the ordinary course of business, even if the property is subject to liens and other "interests," but only where the requirement of §363 are met. Of particular significance is §363(f), which allows the Trustee or DIP to sell property of the estate free of "interests" under

five circumstances:

1) applicable nonbankruptcy law permits sale of such property free and clear of the affected interest;
2) the holder of the affected interest consents;
3) the interest in issue is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
4) the interest in issue is in bona fide dispute; or
5) the holder of the affected interest could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

The proponent of the sale must give 21 days' notice to creditors and parties in interest and must describe the proposed sale is reasonable detail. See Bankruptcy Rule 2002(a)(1), (c)(1); *In re Cummins Utility, L.P.,* 279 B.R. 195, 198 (Bankr. N.D. Tex. 2002). However, this twenty-one day period may be reduced. Bankruptcy rule 9006(c)(1). Historically, the notice period is subject to reduction to permit disposition of perishable assets. However, the number reasons justifying a sale on reduced notice has seems to be multiplying. Thus, in *In re Lehman Brothers Holdings, Inc.*, Bankruptcy Case No. 08-13555, the case was filed on September 15, 2008, and the Bankruptcy Court for the Southern District of New York authorized the sale of $1.8 billion in assets on September 19, 2008 with 2 days notice of the sale. See Transcript of Hearing, September 19, 2008, p. 250 (authorizing the sale on abbreviate notice justified by the incalculable harm to "the debtor, its estates, the customers, creditors, generally, the national economy and the global economy.") Creditor approval is not required, but creditors may object and force a hearing at which the objecting creditor has the burden of proving the validity, extent, and priority of its lien interest.(§ 363(p)(2)).

There are no real restrictions in § 363 on how assets may be used, sold or leased. Thus, the proposed sale may be a specific asset to a known party pursuant to a stated offer, a class of assets may be placed up for auction according to specific procedures, or a known offer may be used to set a minimum sales price under specific conditions, with that offer being used as a "stalking horse" for better offers during a limited period.

If an objecting party loses, and a sale is authorized on conditions to which it continues to object, a stay of implementation of the order under § 363 must be sought in connection with any appeal. Otherwise, the appeal may be moot as the only issue reviewable on appeal after the sale closes is whether the purchase was made in good faith. Special problems may arise in the event that an interest holder is not given proper notice as due process issues will arise.

C. Grounds for Approval of Use, Sale or Lease (but usually Sale)

Of the five circumstances under which use, sale or lease of property of the estate free of "interests" may be authorized, obviously Section f(2), which allows sale with consent of the affected interest, does not generate too much controversy. The other four circumstances under which a sale may be made have been the subject of a greater degree of debate.

1. Use of Non-bankruptcy Law - Bankruptcy Code § 363(f)(1)

This provision is vague, and the case law addressing its meaning is limited. Its purpose is to recognize that if the debtor could sell the property outside of bankruptcy, it can do so in a bankruptcy. See George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 Am. Bankr. L.J. 235, 244 (2002) ("Essentially, this recognizes that there is no reason to limit preexisting rights and

remedies in a liquidation or reorganization to benefit creditors and parties in interest.") An example would be where state law allows restrictive covenants to be voided under the doctrine of changed circumstances. See. H. Mattingly, *"Sale of Property of the Estate Free and Clear of Restrictions and Covenants in Bankruptcy*," 4 Am. Bankr. Inst. L. Rev. 431 (1996). However, courts have concluded that the applicable non-bankruptcy law supporting the sale must actually be available to the debtor. Thus, the fact that property can be take under eminent domain law by the state does not authorize the debtor to use the same standards in a sale. See *In re Haskell L.P.,* 321 B.R. 1 (Bankr. D. Mass. 2005).

2. Sales Price Exceeds Aggregate Lien Value - Bankruptcy Code § 363(f)(3)

The language of this provision appears straightforward, a sale may proceed if the sales price exceeds the aggregate value of all liens on such property. However, some Courts have interpreted the phrase "value of all liens" as meaning the value of property subject to liens. *In re Terrace Gardens Park P'ship*, 96 B.R. 707, 712 (Bankr. W.D. Tex. 1989). Property having a value less than the aggregate of all liens may thus be sold with the undersecured liens receiving only the value of their interest. This rule is not universal. *In re Feinstein Family P'ship,* 247 B.R. 502 (Bankr. M.D. Fla. 2000). Although the Fifth Circuit has cited *Terrace Gardens* with approval on other grounds, there are no reported decisions from Fifth Circuit and courts in other districts of Texas addressing the question. *See* Jordi Guso and Paul A. Avron, *Defining "Value" in 11 U.S.C. 363(f)(3): Is Face Amount of the Claim Secured by the Lien or the Economic Value of the Lien?*, 23-9 ABIJ 36 (Nov. 1, 2004) for a more detailed analysis of § 363(f)(3).

3. Interest is Subject to a Bona Fide Dispute - Bankruptcy Code § 363(f)(4)

A sale may take place if the interest is subject to a *bona fide* dispute (usually with the interest attaching to the proceeds until the dispute is resolved). The Code does not define *bona fide* dispute in this context. In *In re Octagon Roofing*, 123 B.R. 583 (Bankr. N.D. Ill. 1991), the Court looked to the standard established in the context of an involuntary bankruptcy (discussed above). There are no reported decisions from the Fifth Circuit or Texas courts on this issue.

4. Interest Holder Can be Compelled to Accept Money for Interest - Bankruptcy Code § 363(f)(5)

Section 363(f)(5) authorizes a sale free of an interest in the affected property if the debtor could compel the interest holder to accept a money satisfaction of such interest in a legal or equitable proceeding. *WBQ Partnership v. Commonwealth of Virginia Dep't of Med. Assistance Services (In re WBQ Partnership)*, 189 B.R. 97, 106 (Bankr. E.D. Va. 1995). A spectrum of authority exists interpreting this section ranging from a narrow application to one so broad as to find § 363(f)(5) applicable in virtually all cases. The broadest application is found in *In re Trans World Airlines, Inc.*, 322 F.3d 283, 290-91 (3d Cir. 2003), which essentially holds that if an interest in property can be valued, it can be disposed of under § 363(f)(5). The narrow application is illustrated by *Clear Channel Outdoor Inc. v. Knupfer (In re PW LLC*), 391 B.R. 25 (B.A.P. 9th Cir. 2008), where the appellate panel held that § 363(f)(5) only applied when an interest holder could be compelled in a legal or equitable proceeding to accept less than full payment of its debt (thus preserving the full amount of a junior lien).

There are no Fifth Circuit opinions addressing this section. In *GBL Holding Co. Inc. v. Blackburn/Travis/Cole Ltd.*, 331 B.R. 251 (N.D. Tex. 2005), the Court placed the Northern District toward the more expansive end of the spectrum of interpretation. In *GBL Holding*, the court concluded that since it had the option to award damages in lieu of specific performance of a real estate contract (and the purchaser could not insist on specific performance under Texas law),§363(f)(5) authorized the sale of property free and clear of the claims of the prospective purchaser because it could be compelled to accept a money judgment.

D. Concerns to Contractors and Supplies in Connection with §363 Sales

Under current market conditions a sale of assets under § 363 as a practical matter is not likely to generate proceeds for payment to unsecured creditors. Consequently, the use of sales under § 363 is criticized as being little more than a court supervised foreclosure by the secured creditor. See Jason Brege, *An Efficiency Model of Section 363(b) Sales*, 92 Va. L. Rev. 1639, 1640 (2006)("Section 363(b) appears to offer a side door to escape the rigors of the typical bankruptcy plan confirmation."). Sometimes a secured creditor will earmark or carve out a portion of the sales proceeds for unsecured creditors to make the sale more palatable to the court, but that is not always the case. Thus, if a contractor or supplier has only an unsecured or even an administrative priority claim, a sale under§ 363 may not be a promising sign. Such sales may not yield funds sufficient to pay anyone other than the secured creditor whose collateral is being sold, and the unsecured contractor or supplier may not be in a position to prevent such sale. Contractors or materialmen with lien claims will, in contrast, wish to be particularly alert to Section 363 sales as, when combined with the preclusion issues discussed elsewhere, vigilance is required to preserve such interests through the process established under§ 363.

As discussed above, the use of § 363 is increasing, while the standards under which such sales, particularly of all of the assets, may be authorized is arguable growing less distinct and more expediency-based. At a policy level, a sale of all of the assets seems to be authorized with an unsatisfactory level of precision. At a statutory level, many aspects of § 363(f) itself seem equally imprecise. What is certain is that if a lien interest is affected, a contractor or supplier must appear and participate, or risk losing an otherwise valid lien claim.

E. Adequate Protection on an Interest Affected by a Sale

Section 363(e) entitles a party with an interest in the property to be sold to request that the Court prohibit the sale or condition it so that such objecting party's interest is adequately protected. Thus, if the § 363 motion itself does not address the issue, § 363(e) empowers an affected creditor to appear and ask that its be compensated for the loss of its interest in the property. Consequently, a contractor or supplier with a valid lien may appear and assert that its rights under the lien be adequately protected.

XII. Executory Contracts

A. Determination of Status of a Contract as an Executory Contract

1. Defining an Executory Contract

Section § 365 authorizes a trustee or debtor-in-possession to assume, assign or reject executory contracts and unexpired leases based on the best interest of the estate. Section §365 is intended to implement the purpose of the Bankruptcy Code to rehabilitate debtors and allow them to continue in business, where appropriate. Under § 365 the Debtor is permitted to evaluate its contracts, keep favorable contracts to generate money to pay creditors' claims and reject burdensome contracts to lessen the loss from continuing to perform. *In re Chateaugay Corp.*, 10 F.3d 944, 954-55 (2d Cir. 1993). The Bankruptcy Code does not define the term "executory contract" and uses it as though the meaning is patently obvious. The legislative history to the Bankruptcy Code indicates that a contract is usually deemed executory when "performance remains due to some extent on both sides." H.R.Rep. No 95-595, Cong., 1st Sess., 347 (1977); *See also Phoenix Exploration v. Yaquinto (In re Murexco Petroleum, Inc.*), 15 F.3d 60, 62-63 (5th Cir. 1994)(citing *NLRB v. Bildisco & Bildisco,* 465 U.S. 513, 522 n.6,(1984). The majority of bankruptcy courts use the definition developed in 1973 by Vernon Countryman, a law professor at Harvard University, which defines an executory contract as one which, as of the date of the case filing, requires some form of

performance still be due of both parties to the contract such that the failure to complete performance would be a breach of contract. Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973). A contract is no longer executory when the only obligation one party has is an obligation to pay money. *See Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.* (*In re Richmond Metal Finishers, Inc.*), 756 F.2d 1043 (4th Cir. 1985); *Pace v. Computer Utilization, Inc.* (*In re Computer Utilization, Inc.*), 508 F.2d 673 (5th Cir. 1975).

Thus, a construction contract where progress payments are made as work progresses is likely an executory contract (as long as it is not yet completed), as might be partially fulfilled purchase order. However, not all purchase orders are executory contracts. *See In re Dana Corp.*, 2007 LEXIS 3927, *8 (Bankr. S.D.N.Y. Nov. 14, 2007) (*citing Advanced Plastics Corp. v. White Consol. Indus.*, 828 F. Supp. 484, 487 (E.D. Mich. 1993), *aff'd* 47 F.3d 1167 (6th Cir. 1995)). Rather, "[a] blanket purchase order is not a contract for a specific volume of parts, nor is it a requirements contract obligating the purchaser to continue to buy parts from the supplier." *Id.* "Each time a specific release under a blanket purchase order is fulfilled by the supplier and paid by the purchaser, the contractual relationship in essence ends unless the purchaser issues another release." *Id.* "Thus, where no minimum duration is stated in the contract, the general rule is that it is terminable at will by either party." *Id.*

2. Effect of Termination Prior to Case Filing and Lapse Prior to Assumption

The status of the contract is largely determined as of the filing date of the petition. *COR Route 5 Co., LLC v. Penn Traffic Co. (In re Penn Traffic Co.)*, 524 F.3d 373, 381 (2d Cir. 2008). Thus, a contract terminated for breach of contract prior to the filing of a bankruptcy petition is not subject to assumption under §365. *Schokbeton Indus., Inc. v. Schokbeton Prods. Corp.*, 466 F.2d 171 (5th Cir. 1972). Unlike other assets of the debtor, the interest in an executory contract does not automatically vest in the bankruptcy estate at the time of filing, but rather upon the assumption of the contract. *Turner v. Avery*, 947 F.2d 772 (5th Cir. 1991) *cert. den'd* 504 U.S. 985 (1992); *Matter of Tonry*, 724 F.2d 467 (5th Cir. 1984) *(Note: the principle that an executory contract is not property of the estate under Code §541 is a shift from older lines of decision).* Consequently a contract which expires or otherwise terminates by its own terms (other than just because bankruptcy was filed) during the period between the filing of the case and the assumption cannot be assumed. *See, e.g.*, *Hazen First State Bank v. Speight,* 888 F.2d 574 (8th Cir. 1989); *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1213 (7th Cir.), *cert. denied*, 469 U.S. 982 (1984); *In re Beverages Int'l Ltd.*, 61 B.R. 966, 972 (Bankr.D.Mass.1986); *In re Heaven Sent Ltd.*, 37 B.R. 597, 597-98 (Bankr.E.D.Penn.1984).

3. Ipso Facto Clauses

Contracts often contain clauses declaring a default in the event a party becomes insolvent or files bankruptcy. A contract may also contain a clause prohibiting modification in bankruptcy. Such clauses, called “ipso facto” clauses, generally have no effect.(§ 365(e)(1)). Ipso facto clauses are enforceable in connection with certain types of financial contracts and personal property in certain contexts in personal bankruptcies (that are also exempted from the automatic stay), but these issues are beyond the scope of this paper. Regardless of their general ineffectiveness, parties continue to add them to contracts in case circumstances arise to give them effect. Someday, they may.

B. Status of the Contract After Filing, but Before Action on Assumption or Rejection.

Special rules govern nonresidential real property leases and essentially require continued payment of rent after 60 days. (§365(d)(3)). Otherwise, the Bankruptcy Code is silent on the rights and obligations of the parties to an executory contract during the period between the filing of the petition and the time of assumption or rejection. *In re National Steel Corp.*, 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004). However, courts

generally hold that an executory contract remains in effect pending assumption or rejection by a debtor. *In re Public Serv. Co. of N.H.*, 884 F.2d 11, 14 (1st Cir. 1989); *In re Rhodes Inc.*, 321 B.R. 80, 91 (Bankr. N.D. Ga. 2005); *National Steel Corp.*, 316 B.R. at 305; *Interstate Gas Supply v. Wheeling Pittsburgh Steel Corp.* (*In re Pittsburgh-Canfield Corp*.), 283 B.R. 231, 238 (Bankr. N.D. Ohio 2002); *Matter of Travelot Co.*, 286 B.R. 462, 466 (Bankr. N.D. Ga. 2002). Most of the cases addressing the issue are cited for the proposition that pending assumption or rejection, the non-debtor party must continue to perform all its obligations under the contract, or be in breach thereof, even if the debtor is not performing. *In re Pittsburgh-Canfield Corp.* at 238; *In re Pacific Gas and Electric Company*, 2004 U.S. Dist. LEXIS 22023 (S.D. CA 2004). Indeed, in some cases the debtor has sought, and obtained, injunctive relief compelling the non-debtor party to continue its performance under the contract. *In re Nat'l Steel Corp*., 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004); *In re Pittsburgh-Canfield Corp*., 283 B.R. 231, 238 (Bankr. N.D. Ohio 2002).

Recently, in light of the predominance of "just in time" inventories, larger bankruptcies such as those of General Motors Corporation and Chrysler LLC, and weaker overall economic circumstances, this conventional wisdom has been questioned. *See* Risa Lynn Wolf-Smith, *Must Suppliers Continue to Supply on Credit During the Slide into Bankruptcy? Heck No!*, 28-3 ABIJ 26 (Apr. 1, 2009). In her article, Ms. Smith argues that most of the cases addressing the obligation to continue performance deal with the question of whether a creditor who suspends performance is in breach of the contract so that their claim is impaired, and not with the question of whether a non-debtor supplier must continue to supply post-petition. However, Ms. Smith's argument, while well reasoned, is not yet supported by case law. Therefore a non-debtor party should be careful in contemplating unilateral suspension of performance. This is particularly true in the Western District of Texas where the non-debtor cannot unilaterally suspend performance. *See In re El Paso Refinery LP*, 196 B.R. 58, 72 (Bankr. W.D. Tex. 1996).

C. Procedure

1. Timing

Special assumption rules exist in a Chapter 7 deeming the lease of *residential* real estate or personal property rejected if it is not assumed within sixty days of the filing of the case (or any extension granted upon specific request.) (§365(d)(1)). Similarly, special assumption rules exist in Chapter 11 for the assumption of the lease of *non-residential* real estate that require action on the assumption, rejection or assignment within 120 days of the filing of the case. (§ 365(d)(4)). As to all other contracts in all chapters, § 365(d)(2) does not require action on the assumption, rejection or assignment until the confirmation of his plan.

The non-debtor party cannot force the rejection of the contract or terminate the contract. However, the non-debtor may request that the court shorten the time within which the debtor must act on a contract to allow for special situations where the non-debtor could be prejudiced by the debtor's inaction. (§ 365(d)(2)). However, how soon the non-debtor may ask, and how much the time may be shortened is determined on a case-by-case basis. Some courts have held that requiring a decision within two months of the petition in a complex case is unreasonable. Most courts interpreting § 365(d)(2) have applied a balancing test to determine the appropriate limitation on the deadline for the debtor to make its determination. The factors considered include, but are not limited to: 1) the nature of the interests at stake; 2) the balance of harm to the respective parties and the creditors as a whole; 3) the good to be achieved; 4) the safeguards afforded to the parties; 5) the damages that the non-debtor will suffer beyond the compensation available under the Bankruptcy Code; and 6) the importance of the contract to the debtor's business and reorganization. *In re Adelphia Communications Corp.,* 291 B.R. 283, 293 (Bankr. S.D.N.Y. 2003).

2. Non-actionable Contracts

Not all executory contracts are subject to assumption or assignment. Section 365(c) identifies certain types of contracts that the debtor cannot assume or assign. These are generally:

a. contracts where state or federal law excuses a party from accepting performance from or rendering performance to one other than the debtor and such party does not consent. Most commonly this category consists of personal service contracts. (§ 365(c)(1));

b. contracts to make loans or other financial accommodations.(§ 365(c)(2));

c. nonresidential real estate lease in a shopping center and the proposed assignment will upset tenant mix. (§ 365(c)(3)); and

d. aircraft terminal gate leases must all be assumed or assumed and assigned to the same person unless the airport consents otherwise.

The limit on assumption of contracts to make loans or other financial accommodations has particular significance to contractor and suppliers as it is likely to restrict a debtor's ability to assume or assign a surety bond. *See In re Edwards Mobile Home Sales, Inc*., 119 B.R. 857 (Bankr. M.D. Fla. 1990) (bond issued to debtor mobile home seller, as prerequisite for obtaining state license, was non-assumable financial accommodation).

3. Standards

Action on an executory contract (assumption, rejection or assignment) is governed by § 363 and Bankruptcy Rule 6006. The debtor may either file a motion seeking action on the executory contract under Bankruptcy Rules 6006 and 9014, or may incorporate action on the contract into its plan of reorganization. *See* § § 1123(b)(2), 1222(b)(6), 1322(b)(7); *see also Milstead v. Tele Media Broad., Inc.* (*In re Milstead*), 197 B.R. 33 (Bankr. E.D. Va. 1996). The right to decide whether to assume or reject the contract lies completely with the Debtor, subject to the court's review of whether: 1) the debtor's business judgment is erroneous; 2) the benefits of the contract are too speculative; or 3) the debtor fails to meet the statutory requirements as to cure and assurance of future performance. § 365(b); See also *Lubrizol Enter., Inc. v. Richmond Metal Finishers, Inc.* (*In re Richmond Metal Finishers, Inc.*).

4. All or Nothing (But Really What Can be Negotiated)

A debtor may assume or reject executory contracts, but must assume an executory contract as a whole or not at all. *Century Indem. Co. v. Nat'l Gypsum Co. Settlement Trust* (*In re Nat'l Gypsum Co.*), 208 F.3d 498 (5th Cir. 2000) ("Where the debtor assumes an executory contract, it must assume the entire contract, *cum onere*-the debtor accepts both the obligations and the benefits of the executory contract."); *In re Gardinier, Inc.*, 831 F.2d 974, 976 (11th Cir. 1987) *cert den*. 488 U.S. 853. If the debtor wishes to assume the contract, the debtor must "promptly" cure all pre-filing defaults, compensate ***or*** provide adequate assurance of prompt compensation to the non-debtor party for actual pecuniary loss resulting from default, possibly including damages arising from the passage of time and increases in costs, and provide adequate assurance of future performance. (§ 365(b)(1)(A)). BAPCPA legislatively affirmed that the cure obligation also includes most non-monetary defaults. (§ 365(b)(2)(D)). *See In re Empire Equities Capital Corp.*, 405 B.R.

687 Bankr. S.D.N.Y. 2009).

Determining the debtor's cure obligations is fact-specific. *In re General Oil Distributors, Inc.*, 18 B.R. 654 (Bankr. E.D.N.Y. 1982). Courts generally stress a policy against forfeiture to the detriment of other creditors and the debtor. Thus, prompt remedy of financial defaults and credible arrangements to care for future performance, including third party assistance and debtor agreement to remedy non-financial defaults, are usually sufficient to approve assumption of the contract. Adequate "assurance" of performance is not "insurance." Therefore, courts will not usually insure complete performance, but will allow the non-debtor party to return to court later if the debtor defaults after assumption.

Although a debtor must act on each contract as a whole, it is not require to assume all contracts with a non-debtor party. If the debtor engages in cherry picking its contracts, the question presented is whether the agreements in issue constitute one single integrated contract or several separate and distinct contracts which may be assumed or rejected separately. The severability of contracts is generally determined as a matter of state law. *Mirant Corp. v. Potomac Elec. Power Co*., 197 Fed.Appx. 285 (5th Cir.2006). Texas law on the issue, as applied in the bankruptcy context, was reviewed in *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 741-42 (5th Cir. 1996). In determining whether documents constitute one agreement, the intent of the parties is the principal determinant of divisibility. *Id*. at 739. *See also Lifemark Hospitals v. Liljeberg Enterprises (In re Liljeberg Enterprises, Inc.)*, 304 F.3d 410 (5th Cir. 2002); *In re Wolflin Oil, L.L.C ,* 318 B.R. 392 (Bankr. N.D. Tex. 2004); *In re Cafeteria Operators, L.P.*; 299 B.R. 384 (Bankr.N.D.Tex.2003); *In re FFP Operating Partners, L.P.;* 2004 Bankr. LEXIS 1192 (Bankr.N.D. Tex.2004).

D. Assignment of Assumed Contracts

The debtor may also wish to assign the contract to retain the value of a favorable contract on which it cannot act. In order to assign the contract, the debtor must assume it and meet all of the necessary assumption requirements discussed above. After a contract or lease is assumed and assigned the debtor has no further liability regardless of what the contract or lease states. (§ 365(k)). However, the non-debtor party, § 365(f)(2) may require the provision of adequate assurance of future performance by the assignee.

E. Effect of Contract Rejection

Finally, if the debtor believes a contract is burdensome, the contract may be rejected. Rejection of an executory contract is a breach and the other party may file a claim for damages arising from that breach. (§ 365(g)). Regardless of the time of the rejection, the resulting breach is deemed to have occurred prior to the date of the filing so that the creditor's claim is deemed to be pre-petition and not administrative. The non-debtor party may assert a claim for all damages suffered, subject to offset of amounts owed the debtor by the non-debtor party. (The rejection of a lease of property is subject to certain ceilings not generally applicable to circumstances involving contractors and suppliers, but described in § 506(b)). Some courts have held that an underlying principle to the rejection of a contract is the acknowledgment of the validity of the contract. Therefore, when there is a rejection, the debtor may not later assert in defense of a claim for damages for rejection any claim foreclosed by the judicial finding that the debtor failed to perform its obligations under the contract.

The rejection of a collective bargaining agreement is governed by § 1113 and may only be approved if the court finds the debtor made a good faith proposal for modifying and assuming the agreement which was refused by the representative for the employees, and the balance of the equities favors rejection. Modification of the payment of insurance benefits to retirees is governed by § 1113(c)(3). These payments

may only be modified after notice and a hearing only if the modifications are essential to the continuation of the debtors business or are necessary to avoid irreparable harm. However, these issues are not particularly relevant to contractors or suppliers.

F. Breach of an Executory Contract After Assumption

If a contract is assumed, and then later breached by the debtor, the damages resulting from such breach are an administrative claim against the estate. If the case is converted to a Chapter 7 after assumption in Chapter 11, the claim is an administrative claim of the Chapter 11 case, which will rank higher in priority than unsecured claims, but lower than administrative claims of the Chapter 7 case.

G. Options for Contractors and Suppliers

Continuing to deal with a debtor in bankruptcy may be unattractive even if the debtor is current on payments, which is usually not the case. As discussed above, during the limbo period between the filing of the case, and action by the debtor on an executory contract, the courts currently appear to require that the non-debtor continue performance of the contract. The non-debtor party would likely be able to make an administrative claim for the value of materials acquired or services provided post-petition, but will not receive immediate payment absent action in court seeking it. In reviewing the action available to a non-debtor contractor or supplier, several options are available and several factors must be considered.

In some cases the issue will be avoided by the debtor offering to make the supplier a critical vendor, thereby allowing the debtor to pay pre-petition debt and usually incorporating the duty to pay for post-petition deliveries or work on a current basis. However, as discussed above, debtors are using critical vendor motions in new and perverse ways, so any invitation to continue supplying as a critical vendor should be carefully reviewed.

If no critical vendor resolution seems forthcoming, the next step may be to determine whether the debtor engaged in a first material breach of the contract prior to the filing of the petition. Generally the debtor will have fallen out line with customary terms, but that may not be enough. If the debtor has committed a first material breach, the non-debtor party may be excused from continuing performance. *In re Lucre Inc.*, 339 B.R. 648 (Bankr. W.D. Mich. 2006), *aff'd on other grounds*, 471 F. Supp. 845 (W.D. Mich. 2007). However, suspending performance and arguing first material breach may simply be an invitation to an injunction hearing in bankruptcy court, where the equities may perversely seem to be with the debtor after consideration of the impact on other creditors.

Alternatively, a non-debtor party may seize the initiative by filing a motion pursuant to § 365(d)(2) seeking a shortened deadline for action on the contract, coupled with a request for some assurance of payment on a current basis until the debtor decides. *See In re Continental Energy Assocs. Ltd. Pshp*., 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995); *Matter of Travelot Co*. (debtor would be required, before expiration of shortened deadline, to deposit with court cash sufficient to cure defaults, both pre- and post-petition).

Other factors to consider in deciding whether to seek assumption or rejection is determining which option is actually better for the non-debtor supplier or contractor. A number of courts have held that assumption of a contract forecloses any effort to recover a preferential transfer as pre-petition defaults must be cured. *In re Kiwi Int'l Airlines, Inc.*, 344 F.3d 311, 314 (3d Cir. 2003); *In re Teligent Inc.,* 306 B.R. 752, 756 (Bankr. S.D. N.Y. 2004); *Philips Services Corp. v. Luntz (In re Philip Services, Inc.),* 284 B.R. 541, 553 (Bankr. D. Del. 2002), *aff'd.,* 303 B.R. 574 (D. Del. 2003). Thus, a non-debtor that received substantial payments in

the days before bankruptcy might want to take steps to encourage assumption by advising the debtor of its flexibility on cure obligations, even if it must compromise on what will be required to cure any defaults in connection with assumption.

XIII. Setoff and Recoupment

A. Recognition and Effect of Setoff and Recoupment

Setoff and recoupment are related equitable principles, arising from the law governing counterclaims, which recognize the efficiency of allowing two parties to balance the accounts outstanding between them. Setoff allows a general balancing of all accounts between parties to diminish a plaintiff's demand, whereas recoupment allows a defendant to diminish a claim relative to a specific transaction. Section 553 preserves any non-bankruptcy right to setoff which arises independently under applicable state or federal law. *See Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 19 (1995). Therefore, the nature, existence, and enforceability of claims sought to be set off is to be determined by applying the law of the state where the operative facts occurred. *See In re Williams*, 61 B.R. 567, 571 (Bankr. N. D. Tex. 1986). Recoupment is not expressly addressed by § 553, but is an equitable doctrine that has long applied in the bankruptcy context. *See In re U.S. Abatement Corp.,* 79 F.3d 393, 398 (5th Cir.1996). *See also* Shalom L. Kohn, *Recoupment Re-Examined*, 73 Am. Bankr. L.J. 353, 354-355 and fn 77 (1999)("as recoupment is a right similar to, but more powerful than, setoff, it would be illogical to assume that setoff was preserved but that recoupment was prohibited.") Where setoff and recoupment are authorized, § 506(a) converts the right into a secured claim to the extent of the funds in issue (and an unsecured claim to the extent the amount subject to setoff is less than the amount of such allowed claim). *In re Corland*, 967 F.2d 1069, 1077 (5th Cir. 1992).

Non-bankruptcy courts often recognize the right to recoupment and setoff without distinguishing between them. *See* David G. Epstein, *Recoupment: Apples, Oranges and Fruit Basket Turnover*, 58 SMU L. Rev. 51 (2005). However, in bankruptcy the difference between the two is significant. Setoff is subject to the automatic stay, and recoupment is not. *See In re Corland Corp*., 967 F.2d 1069, 1076 (5th Cir. 1992); *In re Holford*, 896 F.2d 176, 179 (5th Cir. 1990). Perhaps more importantly, recoupment does not require "mutuality" (discussed below) and may cross the threshold established by the petition date-with pre-petition claims being recouped against post-petition claims and vice versa. *See In re Midwest Serv. and Supply Co*., 44 B.R. 262 (D. Utah 1983) (contractor allowed to recoup a post-petition debt from a pre-petition claim by applying pre-petition overpayments to post-petition work).

B. Setoff

A creditor's right to setoff of its claims against those the debtor holds are recognized and preserved under the following circumstances:

1) the creditor holds a "claim" against the debtor;
2) the creditor owes a "debt" to the debtor that also arose before the commencement of the case;
3) the claim and the debt are "mutual" (but note they must be held in the same capacity, *i.e.*, each must owe the other in his own name and not as a fiduciary); and
4) the claim and debt are each valid and enforceable.

See IRS v. Luongo (In re Luongo), 259 F.3d 323, 334 (5th Cir. 2001) (citing *Braniff Airways, Inc. v. Exxon Co.*

USA, 814 F.2d 1030, 1035 (5th Cir. 1987)); *In re Frontier Fertilizer & Chem. Co., L.L.C.*, 2009 Bankr. LEXIS 3554 (Bankr. N.D. Tex 2009).

The element of mutuality is where setoff often breaks down. Although the term "mutual debt" is not defined in the Bankruptcy Code, it has been addressed numerous times by courts examining § 553. The definition most universally accepted is that the debt and the claim are in the same right; the debt and the claim are between the same parties; and the parties stand in the same capacity. *Lain v. LZ Speciality Ins. Co. (In re Senior Living Properties, L.L.C.),* 309 B.R. 223, 270 (Bankr. N.D. Tex. 2004); *Photo Mechanical Servs. v. E.I. Dupont De Nemours & Co. (In re Photo Mech. Servs., Inc.),* 179 B.R. 604, 615 (Bankr. D. Minn. 1995); *In re Harold Rinehart*, 76 Bankr. 746 (D. S. D. 1987). As discussed above, the pre-petition entity filing bankruptcy, and the bankruptcy estate managed by the Trustee or the DIP are legally distinct entities. As a result, no mutuality exists where one part of the obligation arises prior to the filing of the case, and the other part after the filing. Pre-petition obligations may be set off against pre-petition debts, and post-petition against post-petition, but the barrier arising on the filing date may not be crossed. The Bankruptcy Code does contain statutory exceptions to these rules which allow setoff of pre-petition and post-petition obligations in the context of certain financial contracts (§362(b)(7)), but otherwise crossing the petition date is not permitted.

Under state law, mutuality may often be supplied by contract. Thus, a corporation and its subsidiaries may contractually agree with third parties that the claims of the collective entities may be setoff against debts owed by any entity. However, arrangements authorizing such "triangular" setoffs are currently not recognized in a bankruptcy context. *In re SemCrude, L.P.*, 399 B.R. 388, (Bankr. D. Del. 2009). However, denial of a right to triangular setoff is subject to criticism. Martin J. Bienenstock, Chris DiAngelo, Eileen Bannon, and Lee J. Cassey, *Are Triangular Setoff Agreements Enforceable in Bankruptcy?*, 83 Am. Bankr. L.J. 325 (Spring 2009) and the prohibition of triangular setoff has not stabilized and may be subject to change.

C. Recoupment

A right to recoupment arises where the creditor's claim against the debtor and the debtor's claim against the creditor arise out of the "transaction." *Kosadnar v. Metro Life Ins. Co. (In re Kosadnar),* 157 F.3d 1011, 1013 (5th Cir. 1998); *In re Holford,* 896 F.2d 176, 178 (5th Cir.1990); *In re Mirant Corp*., 310 B.R. 548, 560 (Bankr. N.D. Tex. 2004); *In re Jones,* 122 B.R. 246, 248 (W.D.Pa.1990); *In re Vaughter,* 109 B.R. 229, 232 (Bankr. W.D. Tex. 1989). Thus, it is the identity of the transaction that is key. The fact that the same parties are involved, and that a similar subject matter gave rise to both claims does not mean that the two arose from 'the same transaction.'" *In re Vaughter* at 234 (citing *Westinghouse Elec. Corp. v. Fidelity & Deposit Co.,* 63 B.R. 18, 21 (E.D. Pa. 1986)). Courts consider whether the claims "arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations." *Malinowski v. New York State DOL (In re Malinowski),* 156 F.3d. 131, 133 (2d Cir. 1998) (citing *In re University Med. Ctr*., 973 F.2d 1065, 1081 (3d Cir. 1992)). In determining whether the claims arise from the same transaction, the "logical relationship" test is used. *Moore v. New York Cotton Exchange,* 270 U.S. 593 (1926). The Court noted that "'[t]ransaction' is a word of flexible meaning. It may comprehend a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship." *Id*. at 610. The classic recoupment right occurs when a buyer erroneously overpays a seller for goods or services. Courts allow the buyer to recoup its overpayment by reducing the purchase price to the extent of the overpayment.

D. Setoff and Preferences

The preference provisions of §547 (discussed below) do not apply to setoff or recoupment. *In re Dillard Ford, Inc*., 940 F.2d 1507, 1512 (11th Cir. 1991). However, a setoff taking place prior to the filing of the petition may be avoidable under§ 553(b) to the extent that it improved the offsetting creditor's position. *Braniff Airways, Inc. v. Exxon Co., USA,* 814 F.2d 1030 (5th Cir.1987). Improvement of position in applying § 553(b) is determined with reference to the following mathematical formula:

1. The amount by which the claim of the creditor exceeded the debt owing to the debtor on the date of setoff is determined.

2. The same sum for the date 90 days prior to the filing of the petition or for the first date during the 90-day period when the amount of the claim of the creditor exceeded the debt owing to the debtor is determined.

3. The trustee is entitled to recover any amount by which the sum in (2) exceeds that in (1).

Braniff at 1040 (5th Cir.1987).

E. Practical Application of Setoff and Recoupment

A creditor with a potential setoff or recoupment claim can implement an "administrative freeze" pending setoff to avoid a deterioration of its position. *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 19 (1995). Consequently, it is not necessary to turnover property subject to a setoff/recoupment claim. (§542(b)). However, as discussed above, unlike recoupment, setoff cannot be implemented without modification of the automatic stay. As a practical matter, given the risks for guessing incorrectly, it is usually a good practice to seek modification of the stay on grounds of recoupment, or alternatively setoff, rather than unilaterally implement a decision.

XIV. Avoidance Actions Arising under Chapter 5 of the Bankruptcy Code.

The Bankruptcy Code gives the Trustee or DIP the ability to set aside certain categories of transactions taking place prior to the petition (and in some cases post-petition). These avoidance powers are intended to allow the Trustee or DIP to reshuffle transfers taking place prior to a bankruptcy filing to eliminate any advantage gained by certain creditors over others and enable all creditors to share in carving up the debtor's assets. The Bankruptcy Code gives these powers to the estate's representative even thought the pre-petition debtor involved in the transaction and the DIP may effectively be identical but for the statutory creation of the estate. Consequently, these "Chapter 5" claims are another example of the baptismal effect of bankruptcy (discussed above) in which the bankruptcy estate is freed from conduct of the pre-petition debtor.

Section 550 enables the trustee or DIP to recover, for the benefit of the estate, any transfer avoided from any immediate or remote transferee or entity for whose benefit the transfer was made unless a defense blocks the recovery. Additionally, the trustee may recover the property transferred or its value. Section 502(d) also prohibits the allowance of any claim to any entity that is liable to the debtor for an avoided transfer that has not been resolved.

A. Procedure

Avoidance actions are adversary proceedings. Section 546 provides that an action "under section 544, 545, 547, 548, or 553" must be brought within the earlier of two years after the entry of an order for relief or the time the case is closed or dismissed, whichever is earlier. (§546(a)). If a case is converted from a Chapter 11 to a Chapter 7, the statute of limitation provides a newly appointed trustee the later the later of the original two year period, or one year from his appointment if he is appointed prior to the expiration of the original two year period. Section 546(a) and all of the sections listed therein, including §544(b), apply only to pre-petition transfers.

B. The Strong-Arm Powers

Section 544(b) (the "strong-arm clause") acts as a statutory grant to the estate representative of the powers that a lien creditor or bona fide purchaser would have under state law to set aside transfers of property taking place prior to the filing of the petition. Most commonly, these powers are the avoidance of unrecorded or unperfected liens or other "interests in property" of the pre-petition debtor to the extent permitted by state law. *See Anderson v. Conine (In re Robertson*), 203 F.3d 855, 864-865 (5th Cir. 2000); *Gaudet v. Babin (In re Zedda)*, 103 F.3d 1195, 1201 (5th Cir.1997); *Angeles Real Estate Co. v. Kerxton (In re Construction General, Inc.)*, 737 F.2d 416, 418 (4th Cir. 1984); *Paramount Int'l. v First Midwest Bank (In re Paramount Int'l*), 154 B.R. 712 (Bankr. N.D. Ill. 1993); *In re May*, 19 B.R. 655, 658 (D. Fla. 1982); *Moser v. Toyota Motor Credit (In re Davis),* 2009 Bankr. LEXIS 1031 *13, 2009 WL 1033194 (Bankr. E.D. Tex. 2009). Section 544 also authorizes the utilization of state fraudulent conveyance statues. *See In re MortgageAmerica Corp.*, 714 F.2d 1266 (5th Cir.1983). Congress's use of the words "an interest of the debtor in property" necessarily limits the application of §544(b) to pre-petition transfers since there was no estate at the time of a pre-petition transfer. Although the Bankruptcy Code has its own fraudulent conveyance provision, it is subject to a shorter look-back period (except in one case discussed below), and thus the state statutes will more frequently be used.

Generally, a Chapter 7 Trustee cannot transfer the strong-arm powers. *Nangle v. Lauer (In re Lauer)* 98 F.3d 378, 388 (8th Cir. 1996). However, the DIP in a Chapter 11 may do so in connection with the confirmation of a plan. §1123(b)(3)(B). *McFarland v. Leyh (In re Texas Gen. Petroleum Corp.),* 52 F.3d 1330, 1335 (5th Cir. 1995). Often, such a transfer will take place in connection with the creation of a trust for the benefit of creditors. ***Creditors should carefully watch such trusts as they can create a circularity problem whereby a trust is created for the benefit of creditors that is funded by avoidance actions filed against the same creditors.*** The result is the establishment of a process to collect money from creditors who received it so that it can be redistributed back to them minus attorneys and trustee's fees (with some net winners and losers in the process).

C. Lien Avoidance Powers

Section 545 permits a trustee to avoid statutory liens that:

A. attach solely on the basis of an "insolvency-like" event (which may be bankruptcy, state court receivership, or contractual);

B. are not perfected or enforceable against a hypothetical bonafide purchaser for value on the petition date; or

C. are for rent (except that warehouseman's liens are excluded from avoidance).

Section § 101(53) defines as statutory lien as "one arising by statute" and expressly excludes security interests and judicial liens "whether or not such interest is provided by or is dependent on a statute" or "made fully effective by statute."

In the construction context, lien avoidance is most likely to arise with respect to mechanics and materialman's liens. Based on the definition of statutory lien in the Bankruptcy Code, a perfected mechanics and materialman's liens is outside of the scope of the § 545 avoidance provisions (even though it could be said to some extent to arise by statute). *See In re Nucorp Energy, Inc.*, 902 F.2d 729 (9th Cir. 1990); *Schnittjer v. Pippert (In re Carney)*, 396 B.R. 22 (Bankr. N.D. Iowa 2008); *In re Allgeier & Dyer, Inc.*, 18 B.R. 82 (Bankr. W.D. Ky. 1982); *See also Cavazos v. Munoz*, 305 B.R. 661, 681 (S.D. Tex. 2004). However, a constitutional lien and an unperfected statutory lien are subject to avoidance under § 545. *See In re A& R Wholesale Distrib., Inc.*, 232 B.R. 616, 620 (Bankr. N.J. 1999); *McEvoy v. Ron Watkins Inc.*, 105 B.R. 362, 365 (N.D. Tex. 1987); *In re Ernest & Associates, Inc.*, 59 B.R. 495 (Bankr. W.D. Tex. 1985).

D. Fraudulent Transfers

1. Use of the Uniform Fraudulent Transfer Act or Bankruptcy Code Section 548?

The trustee or DIP may undertake to avoid pre-petition transfers through either the incorporation of state fraudulent conveyance law found in the strong-arm clause of § 544 (discussed above) or the fraudulent conveyance statute built-in to § 548. The use of the term "fraudulent" in this context is somewhat misleading as most, although not all, avoided transfers involve questions of valuation and not actual fraud. The elements of an actionable transfer under § 548 and the Uniform Fraudulent Transfer Statute (the "UFTA") (or as locally enacted the *Texas Uniform Fraudulent Transfer Act*, TEX. BUS. & COMM CODE § 24.001 *et seq*.) substantially overlap, as indicated in the chart below. However, there are some significant variances. Under UFTA, most suits must be filed within four years of the transfer which is sought to be set aside while most actions under § 548 reach only transfers occurring within the two years prior to the petition date. However, there are circumstances where these time periods change. UFTA shortens the look-back period to one year under certain circumstances (TEX. BUS. & COMM CODE § 24.010) and extends it to one year after a transfer is discovered or could reasonably have been discovered if the transfer was made with the actual intent to hinder delay or defraud. (TEX. BUS. & COMM CODE § 24.010(a)(1). Section 548 extends the look back period to ten years in circumstances relating to self-settled trusts created with an actual intent to hinder, delay, or defraud. The UFTA also allows recovery of reasonable and necessary attorney's fees. (TEX. BUS. & COMM CODE § 24.013.) As a result, the determination of whether to pursue a transfer under UFTA or § 548 is fact specific.

2. Elements of Fraudulent Transfer Action

The following chart summarizes in rough form the basic elements of the various causes of action available under § 548 and TUFTA. The chart illustrates the substantial overlap between the two statutes.

CONTINUED ON NEXT PAGE

Summary of Elements of Causes of Action (§ 548 and TUFTA)

<table>
<tr><th>Element</th><th>548(a)(1)</th><th>548(a)(2)</th><th>TUFTA 24.005(a)(1)</th><th>TUFTA 24.005(a)(2)</th><th>TUFTA §24.006(a)</th><th>TUFTA §24.006(b)</th></tr>
<tr><td>Transfer involved property of the debtor.</td><td>√</td><td>√</td><td>√</td><td>√</td><td>√</td><td>√</td></tr>
<tr><td>Type of Creditor</td><td>Any</td><td>Any</td><td>Any</td><td>Any</td><td>Existing</td><td>Existing</td></tr>
<tr><td>Transferee</td><td>Any</td><td>Any</td><td>Any</td><td>Any</td><td>Any</td><td>Insider</td></tr>
<tr><td>Look Back Period to Date of Transfer</td><td>2 years* prior to petition</td><td>2 years prior to petition</td><td>Suit within 4 years following transfer/1 after discovery</td><td>Suit within 4 years following transfer</td><td>Suit within 4 years following transfer</td><td>Suit within year following transfer</td></tr>
<tr><td>Transfers made with actual intent to hinder, delay, or defraud a creditor.</td><td>√**</td><td></td><td>√**</td><td></td><td></td><td></td></tr>
<tr><td>Transfer made for less than reasonably equivalent value the transferred asset.</td><td></td><td>√</td><td></td><td>√</td><td>√</td><td></td></tr>
<tr><td>Debtor insolvent when the transfer made or rendered insolvent by the transfer.</td><td></td><td rowspan="3">√***</td><td></td><td></td><td>√</td><td>√</td></tr>
<tr><td>Debtor engaged (or about to engage) in business/transaction for which the debtor’s remaining property was unreasonably small.</td><td></td><td></td><td rowspan="2">√***</td><td></td><td></td></tr>
<tr><td>Debtor intended to incur (or believed the debtor would incur) debts beyond the debtor’s ability to pay as the debts matured.</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Transferee had reason to believe debtor was insolvent.</td><td></td><td></td><td></td><td></td><td></td><td>√</td></tr>
</table>

* Ten years in cases involving self-settled trust or similar device § 548(e).
** Since intent must typically be established indirectly, TUFTA contains a non-exclusive list of “badges of fraud” through which the requisite fraudulent intent may be demonstrated. TEX. BUS. & COMM CODE § § 24.005(b)(1). These indicia are also used in connection with an action under 548(a)(1).
******* Any one of the indicated elements**.**

E. Avoiding Unauthorized Post-Petition Transfers

Section 549 authorizes a trustee or DIP to avoid a transfer of "property of the estate" that occurs after the commencement of the case that is not otherwise authorized by the court or Bankruptcy Code. The court looks at four questions: 1) whether a transfer of property occurred; 2) whether the property was property of the estate; 3) whether the transfer occurred after the commencement of the case; and 4) whether the transfer was authorized by the court or the Bankruptcy Code. No defenses are available, other than to negate one or more of the elements. An action to set aside a post- petition transfer must be commenced by the earlier of two years after the date of the transfer sought to be avoided; or the time the case is closed or dismissed. (§ 549(d)). The §549(d) limitations period is absolute and is not extended by appointment of a trustee. *Rathbone v. Lake (In re Consolidated Partners Investment Co.)*, 156 B.R. 982, 984 (Bankr. N.D.Ohio 1993) Thus, it is possible where a Chapter 11 case is converted to Chapter 7 for the limitations period on a post-petition transfer to run before a Chapter 7 trustee is appointed. *In re H.I.A. of Mt. Vernon*, 80 B.R. 944 (Bankr. S.D.Ill.1987).

F. Avoiding Preferential Transfers

1. Defining a Preferential Transfer

Section 547(b) authorizes the bankruptcy estate to recover pre-petition payments or transfers of assets to creditors if **all** of the following elements are shown:

A. a transfer of an interest of the debtor in property;
B. to or for benefit of creditor;
C. as payment of antecedent (pre-existing) debt;
D. made while the debtor was insolvent (a debtor is rebuttably presumed insolvent during the 90 days prior to the case filing);
E. made within 90 days prior to the petition date (or one year if the recipient is an insider)
F. the transfer enable the creditor to recover more than it would receive in a distribution under Chapter 7.

Section 547(b) applies to both voluntary and involuntary transfers, and therefore execution of a judgment, attachment, service of a writ of garnishment, or implementation of other legal process that recovers property of the pre-petition debtor can be set aside as a preference. As discussed above, §547(b) does not apply to situations that qualify for setoff or recoupment, which are governed by §553(b).

2. Defenses to a Preference Claim

In the construction context, the existence of trust fund and related concepts (discussed above) may give contractors and suppliers a greater chance than most other creditors at negating the requirement that the funds received were property of the debtor. Otherwise when a preference is alleged, the Trustee or DIP is usually able to prove the elements of a preference claim. Consequently, the focus in most preference litigation is on the preference defenses available under §547(c).

Section 547(c) sets forth nine defenses to a preferential transfer claim, with an additional defense being found in §547(h). Three defenses are inapplicable to unsecured credit transaction as they relate to perfection of purchase money security interest (§547(c)(3)), perfection of security interests in inventory

(§547(c)(5)), and alimony and support payments (§547(c)(7)). Four defenses, although important, are fairly mechanical in their application. Section §547(c)(8) and (9) exempt transfers of a value less than a stated amount-$600 in consumer cases and $5,475 in non-consumer cases. Section 547(h) exempts from avoidance those payments made to creditors pursuant to an alternative repayment schedule between the debtor and any creditor of the debtor created by an approved nonprofit budget and credit counseling agency. The remaining defenses shield: 1) substantially contemporaneous transactions; 2) payments made in the ordinary course of business; 3) reduction of the amount of preferential payments by the subsequent advance of additional money or credit ("new value"); and the fixing of a statutory lien. A more substantial body of law has developed regarding each of these last four defenses.

a. Substantially Contemporaneous Transactions - §547(c)(1)

Section 547(c)(1) provides that a trustee may not avoid a transfer of property to the extent that the creditor can show that it was intended to be, and actually was, a substantially contemporaneous exchange for new value. The rationale behind this defense is that the transfer of new value into the estate offsets the amount by which the payment depleted the estate so long as the new value is not less than the value of the preference. Thus, there is no diminution of the debtor's estate.

The new value provided does not have to be paid directly to the debtor as long as the debtor benefits. *Gulf Oil Corp v. Fuel Oil Supply & Terminaling, Inc. (In re Fuel Oil Supply & Terminaling*,) 837 F. 2d 224 (5th Cir. 1988)(creditor cancelled two letters of credit issued for its benefit, causing the issuing bank to release collateral of the debtor). This interpretation is significant for contractors and suppliers as the release of a lien or bond claim may provide contemporaneous new value sufficient to shield payment made on a claim. *Lovett v. Homrich (In re Philip Services Corp*.), 359 B.R. 616, 632 (Bankr. S.D. Tex. 2006); *Lubman v. C.A. Guard Masonry Contr., Inc. (In re Gem Constr. Corp.)*, 262 B.R. 638 (Bankr. E.D. Va. 1998). However, at least in the Northern District, foregoing a right to perfect a lien in exchange for payment is not an exchange of "new value" because "it is not money or money's worth in goods, services, or new credit, nor is it a release of property by the lienor that has previously been transferred to the lienor. *Cimmaron Oil Co. v. Cameron Consultants, Inc.*, 71 B.R. 1005 (Bankr. N.D. Tex. 1987). *Cimmaron Oil* has been criticized by the Fifth circuit in connection with its analysis of §547(c)(6). *See Baker Hughes Oilfield Operations, Inc. v. Cage (In re Ramba*, *Inc.)*, 416 F.3d 394, 400 (5th Cir. 2005)).

b. Payments Made in the Ordinary Course of Business- §547(c)(2)

There are two elements to the ordinary course of business defense:

(1) The debt on which the payment was made must have been incurred in the ordinary course of business;

(2) The transfer must have been made in the ordinary course of business of the debtor and the transferee; ***or*** according to ordinary business terms.

Here BAPCPA made a **significant** change by replacing the word "and" with "or", thereby making the parts of the second prong disjunctive. Consequently, it is now necessary to prove either that a transfer occurred in the ordinary course of the business relationship of debtor and creditor or the according to ordinary business terms of the industry. ***An important point to remember is any deviation in payment terms from those sheltered by a defense is a preference. Therefore, if the debtor suddenly starts making payments much more quickly than the parties' history of dealings, or than is standard in the industry, that***

is as much a problem as when the payments are delayed beyond terms.

In analyzing the prong relating to the relationship between the parties, courts have used the "base line of dealings" between the parties. If the debtor's payments made during the 90-day preference period were in accordance with the base line of dealings established by the parties in the pre-90 day period, they are protected because they are recurring. Payments made by the debtor during the preference period that are inconsistent with the debtor's history of payment preceding the preference were not made in the ordinary course of business of the debtor and are avoidable preferences. Some courts permit the baseline to be established by something less than the entire history of the parties' relationship. *Eggmann v. MRH Corp. (In re Landreth Lumber Co.)*, 2009 Bankr. LEXIS 3686 (Bankr. S.D. Ill. Nov. 23, 2009). However, most courts appear to require examination of the parties' entire history. *Gonzales v. DPI Food Prods (In re Furrs Supermarkets, Inc.),* 296 B.R. 33 (Bankr. D.N.M. 2003) ("*Generally,* the entire course of dealing is considered."); *Plan Admin. Agent v. Coastal Indus. (In re Kevco, Inc.)*, 2005 Bankr. LEXIS 1249 (Bankr. N.D. Tex. June 30, 2005). However, there may be some room for arguing that the base line period should be limited where the parties have a lengthy history.

Calculation of an industry standard in applying the "ordinary business terms" test is more difficult. Without going into a discussion of the numerous cases, suffice it to say that a number of tests exist. The Fifth Circuit has adopted the majority "objective" standard looking to "customary terms and conditions used by other parties in the same industry facing the same or similar problems. *Gulf City Seafoods, Inc. v. Ludwig Shrimp Co., Inc. (In re Gulf City Seafoods, Inc.),* 296 F.3d 363, 368-369 (5th Cir. 2002). *See also Cage v. Wyo-Ben, Inc. (In re Ramba Inc.)*, 437 F.3d 457 (5th Cir. Tex. 2006). In determining the industry to be used, the Fifth Circuit stated that the "creditor should provide evidence of credit arrangements of other debtors and creditors in a similar market, preferably both geographic and product." *Gulf City Seafoods* at 369.

c. Subsequent New Value - §547(c)(4)

If a contractor or supplier, after receiving a preferential payment, sells materials to its customer on credit or provides additional services, such gives rise to a potential subsequent new value defense. The justification for the new value exception is that while the payment of preferences to the creditor diminishes the estate, other creditors are not really worse off, since the subsequent advance of new value replenished the estate. There are two elements in the new value defense:

1) The creditor must give new value not secured by an otherwise unavoidable security interest; and
2) The new value must be given after the preferential transfer.

In the typical new value situation, there will be numerous debits and credits subsequent to the preferential transfer. The Bankruptcy Courts formerly applied a test known as the "net result rule" under which any and all extensions of value during the preference period were available to be offset against all of the preferences. This procedure has been abolished. The Fifth Circuit permits subsequent advances of new value to be used to offset prior (and not just immediately prior) preferences until they are exhausted by subsequent advances of new value. *Williams v. Agama Systems, Inc. (In re Micro Innovations Corp.),* 185 F.3d 329 (5th Cir. 1999). This appears to be the majority rule. *See* Carl N. Kunz III, *New Value Must Remain Unpaid? It's Time to Resole New York City Shoes*, 25-9 ABIJ 36 (Nov. 1, 2006).

Analysis of new value situation is best resolved with reference to a chart analyzing payments and new value. The opinion in *Laker v. Vallette(In re Toyota of Jefferson)*, 14 F.3d 1088 (5th Cir. 1994) sets forth

an example of a helpful format. *Laker v. Vallette* at 1091.

d. The Fixing of a Statutory Lien - §547(c)(6)

Section 547(c)(6) simply states that the Trustee or DIP may not avoid "the fixing of a statutory lien that is not avoidable under section 545." The Bankruptcy Code does not define the term "fixing." *Baker Hughes Oilfield Operations, Inc. v. Cage (In re Ramba, Inc. I)*, 416 F.3d 394, 401 (5th Cir. 2005). However, the Fifth Circuit essentially defines "fixing" to mean the perfection or other attachment of the lien. *See Henderson v. Belknap (In re Henderson*), 18 F.3d 1305, 1308-09 (5th Cir. 1994). A straightforward reading of sections 545 and 547(c)(6) "leads to the conclusion that if a statutory lien has been perfected so as to be enforceable against a bona fide purchaser at any point prior to the commencement of the bankruptcy case, it cannot be avoided by the trustee." *Spicer v. United States, IRS (In re Motion Mktg. Solutions, Inc.)*, 403 B.R. 403, 408 (Bankr. N.D. Tex. 2009). ***As to the construction creditor, the most significant point is that a perfected mechanic's lien is not avoidable as a preference if it is not avoidable under Section 545*****.** *In re Sullivan*, 254 B.R. 661 (Bankr. D. N.J. 2000).

XV. Development and Presentation of a Plan of Reorganization

A complete review of the process whereby a disclosure statement and plan are presented and approved is far beyond the scope of this presentation. However, consideration of some key points is merited as they apply to contractors and suppliers.

A. Plan Development as a Negotiation

The end of the road in any of the reorganization chapter is the development and presentation of a confirmable plan. In chapters 12 and 13, confirmation of the plan is essentially achieved by following the provisions of either section §1225 or § 1325 respectively, with creditors permitted to object that these requirements have not been met. However, in Chapter 11, unless the plan will pay every creditor the entire amount of their claim, the DIP must not only follow the statute but also engage the creditors and achieve some measure of affirmative participation in the approval of the plan. Anything less than full payment (and that is virtually always the case), and the debtor will need approval of at least one class of creditors in order to invoke the "cramdown" provisions on other impaired classes. Often, the class that the debtor targets for approval is that containing the unsecured creditors. The creditors' committee is the primary representative of the unsecureds in the context of these negotiations, but they need not be the only one. Large unsecured creditors, or aggregations of like-situated creditors, may be advised to deal directly with the debtor.

B. Preparation of the Disclosure Statement

Before a plan may be submitted to creditors, the debtor must develop and obtain court approval of a disclosure statement. The disclosure statement is intended to act as a form of prospectus for the plan, and explains the financial consequences resulting from the acceptance or rejection of a plan of reorganization. Section 1125 requires that the disclosure statement contain information which will enable a reasonable investor, typical of holders of claims of a particular class, to make an informed judgment about the plan.
Before a plan proponent may solicit acceptances of its plan, the bankruptcy court must approve the disclosure statement as containing adequate information and the disclosure statement must be distributed to the voting classes. Although it is rare, different disclosure statements may be approved for distribution to different classes of claims. BAPCPA specifically authorizes solicitation of an acceptance or rejection of a plan prior to the filing of the case if the solicitation complies with non-bankruptcy law. Such solicitation may

continue after the filing of the case.

The solicitation of reorganization plans through the distribution of disclosure statements is governed by § 1125. An acceptance or rejection of a plan may not be solicited after the commencement of the case from a holder of a claim or interest unless, at the time of or before such solicitation, the solicitation is accompanied by a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information. (§1125(b)). BAPCPA now provides that adequate information include a discussion of the tax consequences of the plan to the debtor, successors to the debtor and hypothetical investor typical of the claim or interest holders in the case. Most plans already did this, but now it is required.

Courts use different tests to ascertain whether a disclosure statement provides adequate information as defined in Section 1125(a)(l). For instance, some courts have used the "totality of the circumstances test." Under this test, the court asks what information it is feasible to disseminate given the particular facts of the bankruptcy case. The court also inquires into whether the interested parties have access to adequate information through other sources. Several courts have developed checklists of information required to meet the mandates of Section 1125. *In re Malek,* 35 B.R. 443, 443-44 (Bankr. E.D. Mich. 1983); *In re Metrocraft Publishing Service, Inc.,* 39 B.R. 567 (Bankr. N.D. Ga. 1984). These checklists essentially require: 1) a description of the debtor's pre-petition business operations and financial conditions; 2) identification of the assets and debts of the debtor, a description of the plan and how it will be implemented; 3) an analysis of how the assets of the debtor would be distributed if it were in a Chapter 7 liquidation; 4) indentification of significant personnel involved in the business and the businesses dealings with them; 5) a description of pending litigation and the probability of success or failure; 6) tax consequences of plan confirmation. Special rules applicable to small cases may excuse the need for a separate plan and disclosure statement.

C. Development of a Plan of Reorganization

Most plans are proposed by the Debtor, acting alone or sometimes with an Official Committee or a lender. The right to propose a plan belongs exclusively to the debtor for 120 days after order for relief §1121. The debtor may seek to extend the exclusively period, although BAPCPA limited extensions so that the exclusivity period will terminate 18 months from the date of the order for relief. Creditors more rarely seek to shorten it. Eventually though, creditors are allowed to propose plans if the debtor has not confirmed one of its own. If no plan and disclosure statement are filed, confirmation cannot occur and conversion or dismissal may follow.

After a plan is submitted, creditors will vote to approve or reject it by class. Generally, like claims are grouped into a class. However, since obtaining a favorable vote from at least one class is critical, a great deal of maneuvering may accompany classification, and litigation regarding whether the classes have been improperly gerrymandered may arise. An accepting class is one in which the holders of two-thirds in amount and greater than one-half in number of allowed claims, that have voted on the plan, have accepted the plan. §1126(c); Fed. R. Bankr. Proc. 3018. A class that is not impaired under the plan, and each holder of a claim or interest of such class, are conclusively presumed to have accepted the plan, and solicitation of acceptances with respect to such class from the holders of claims or interests of such class is not required. §1126(f). A class is deemed not to have accepted a plan if such plan provides that the claims or interests of such class are not paid or provided property. §1126(g).

Regardless of creditor approval, a plan cannot be confirmed unless it complies with § 1129. In addition to provisions regarding voting on the plan, § 1129(a) also requires that the plan : 1) comply with all applicable provisions of the Bankruptcy Code; 2) be proposed in good faith; 3) disclose all payments made

or promised by the plan or its proponent; 4) identify the management of the reorganized debtor and the compensation to be paid; 5) provide for payment of administrative expense claims; 6) provide for payment of all fees due from the debtor; and 6) provide for payment of all retiree benefits as they existed prior to the bankruptcy or as modified during the case. The court must also find that confirmation of the plan is not likely to be followed by a liquidation or another reorganization

D. Invoking the Absolute Priority Rule

Where a class of unsecured creditors is impaired, a plan is "fair and equitable" only if the allowed value of the claim is to be paid in full or the creditor receives as much as it would in a Chapter 7 and no junior class will receive any interest in the property. §1129(b)(2)(B)(ii). This latter condition (that no junior class may receive any interest) is what is known as the "'absolute priority rule."' *Beal Bank SSB v. Water's Edge Ltd.,* 248 *B.R.* 668, 678 (D. Mass. 2000). The absolute priority rule does not apply where the Chapter 11 debtor is an individual §1129(b)(2)(B)(ii) and 1115. The only other exception to the Absolute Priority Rule is the new value exception. The parameters of the new value exception are still vague despite some discussion by the United States Supreme Court. *Bank of America National Trust & Savings Assn. v. 203 North LaSalle Street Partnership,* 526 U.S. 434,442, 119 S.Ct. 1411 (1999**).**

E. Issue and Claims Preclusion

Confirmation of a plan binds all parties in interest whether the claim or interest holder is impaired or has accepted the plan. (§1141(a)). Once the plan is confirmed and effective, the property under the plan is free and clear of all claims and interests except as otherwise provided by the plan. In interpreting § 1141 of the Code (and the related provisions of Chapter 12 and 13), courts have found that a confirmation hearing constitutes a final determination and consequently afford the confirmation order preclusive effect upon all issues which were raised or which could have been raised but were not. *Matter of Howe*, 913 F.2d 1138 (5th Cir. 1990).

F. Once Its Over

Under § 362(c)(1), the stay of an act against the debtor's property continues until the property which is the subject of the bankruptcy is no longer property of the estate. Confirmation of the plan vests all the property of the bankruptcy estate in the debtor. §1141(b). Consequently, upon confirmation the stay will terminate. Any default under the plan will allow a secured creditor to exercise its rights against the debtor and the collateral. Most plans attempt to replace the automatic stay on the effective date of the plan with an injunction.

XVI. Conclusion

Most contractors and suppliers regard a bankruptcy proceeding as hole where good money will simply follow bad if they hire counsel and become involved. Sometimes they are right. However, under current circumstances in the bankruptcy arena the one certainty is the truth of the rule that "if you snooze, you will lose." Consequently, it is almost always worth a careful look to see what steps can be taken to improve a creditor's position at appropriate stages in the bankruptcy process.