The Global Legal Network
Local Relationships Worldwide

TWO SIDES OF THE SAME COIN: UNDERSTANDING THE COSTS AND BENEFITS OF THE BANKRUPTCY TRANSFORMATION

AUTHORED BY ALFA INTERNATIONAL ATTORNEYS:

Lea Pauley Goff
STOLL KEENON OGDEN PLLC
Louisville, Kentucky
lea.goff@skofirm.com

David A. Lerner
PLUNKETT COONEY, PC
Bloomfield Hills, Michigan
dlerner@plunkettcooney.com

*Article originally written for ALFA International's 2021 International Client Seminar in March 2021.

A. Introduction

The theme of ALFA's 2021 International Client Seminar is transformational change. The bankruptcy process often involves transformational change. This is obvious for Chapter 11 debtors – the entire business is being restructured or sold. The equity holders likely change, the business model may change and these changes often determine whether the business will or will not survive. However, the changes wrought by Chapter 11 also can be transformational for creditors – the Chapter 11 filing of a major customer is often a crisis event for a creditor, as it can mean profit or loss, survival or demise.

The taped presentation on this topic uses a hypothetical Chapter 11 in which debtor and creditor representatives and counsel talk you through the key issues for each side. These written materials give you a glossary for common Chapter 11 terms. They also walk through the statutory cites and major cases for a selection of issues you are likely to see in Chapter 11. The materials also include summaries of U.S. Supreme Court bankruptcy decisions from 2020. They conclude with a review of the new subchapter for small business chapter 11 cases – likely the biggest recent development in this area. These materials are intended for lawyers with business practice sophistication but who are not bankruptcy lawyers.

B. Chapter 11 Glossary

BANKRUPTCY COURT JURISDICTION

The bankruptcy court has jurisdiction over all property of the debtor wherever located in the world. The filing of a U.S. corporation does not necessarily place into bankruptcy its foreign subsidiaries. However, U.S. bankruptcy courts can prevent creditors of the foreign subsidiaries from taking action that would harm the U.S. corporation in bankruptcy. All property of the debtor prior to bankruptcy becomes part of the bankruptcy estate upon filing.

AUTOMATIC STAY

Upon the filing of bankruptcy an automatic stay is put into place. The automatic stay is an injunction stopping virtually all actions against the debtor to recover property, sue the debtor or cancel contracts with the debtor.

DEBTOR IN POSSESSION

Upon filing a Chapter 11, the debtor company becomes a debtor-in- possession and remains in control of its assets. The debtor in possession is a fiduciary for the creditors and has powers as a bankruptcy trustee.

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

CHAPTER 11 TRUSTEE

Upon the motion of the creditors or the United States Trustee, who administers Chapter 11 cases through the U.S. Department of Justice, the court can appoint an independent party as a trustee to operate the Chapter 11 company. A trustee can be appointed if there is fraud or mismanagement by the principals of the debtor operating the debtor company.

CREDITOR COMMITTEE

One or more committees of creditors can be appointed by the Office of the United States Trustee to represent the interests of the creditors. In large Chapter 11 cases there may be more than one creditor committee formed to represent different interests of creditors such as trade creditors, shareholders and employees.

CRITICAL SUPPLIER PROTECTION

A current trend is to have the bankruptcy court determine that certain suppliers are critical to the reorganization of the debtor. The debtor can seek permission from the bankruptcy court to provide for payment to the critical suppliers on their pre-bankruptcy debt. Normally, a debtor may not pay a creditor after the fi ling of bankruptcy for receivables owing prior to bankruptcy, except in the context of a plan of reorganization.

REJECTION/ASSUMPTION OF CONTRACTS

The debtor-in-possession (or trustee) can petition the court to reject contracts that are burdensome to the estate. It can also seek court permission to assume and assign contracts.

RECLAIMING GOODS

A creditor that has supplied goods to the debtor prior to bankruptcy can, through the proper procedures, petition the bankruptcy court to recover the goods supplied to the debtor shortly before the filing of bankruptcy. However, an existing lien on inventory my trump a reclamation right.

SET-OFF

The bankruptcy code recognizes the right to set off mutual debts between a debtor and a creditor. However, a creditor must seek permission from the bankruptcy court to setoff debts.

PREFERENCE RECOVERIES

The debtor in possession (or trustee) has a wide array of claims it can assert against creditors. Among the claims the debtor in possession can assert are claims to recover payments made by the debtor within 90 days of bankruptcy to a creditor. Such lawsuits are called preferences.

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

There are certain defenses that a creditor can raise with the bankruptcy court to avoid having to return funds received from a debtor, such as ordinary course of business and new value.

PLAN OF REORGANIZATION

The debtor-in-possession is provided an opportunity to propose a plan of reorganization to repay its creditors some or all of its money over a period of time. Creditors may vote on a plan, but it can also be approved by the court even if few creditors vote for it. Creditors can also file plans of reorganization, either upon court permission or after the exclusive period of time expires for a debtor to propose such a plan.

CHAPTER 7 – LIQUIDATION

- Frequently used by individuals, not businesses
- Automatic stay imposed
- Means test to avoid abusive filings by individuals
- Trustee appointed to liquidate assets and distribute to creditors
- Debts can be reaffirmed
- Debtor can exempt certain assets from liquidation
- May need to file proof of claim if notified to do so
- Process is generally fast
- Debtor receives a discharge

CHAPTER 11 – REORGANIZATION

- For business that wants to continue operating or sell as a going concern
- Automatic stay imposed
- Debtor usually remains in possession of property (debtor-in-possession)
- Cash collateral order needed to continue operations if a lien on cash and receivables
- No exempt property for businesses
- Debtor will propose a Chapter 11 plan within 120 days of filing
- Creditors vote on or object to plan
- Plan may cram down secured debt to value of property
- Unsecured creditors committee may be formed
- Motions for relief from automatic stay are common and frequently granted in single asset real estate cases

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

CHAPTER 11 - SMALL BUSINESS

- Trustee appointed in every case; ordinarily trustee will not operate the business.
- Only small business debtor may file plan and plan must be filed within 90 days of filing (which may be extended for circumstances beyond debtor's control).
- Loan for principal residence may be modified, if proceeds of loan were used for the business
  plan for confirmation.
- No impaired class needed to vote in favor of the plan for confirmation.
- No absolute priority rule
- Debtor devotes disposable income to fund plan.
- Debt limit is $2.7 million in secured and unsecured debt.
- At least 50% of debts arose from debtors commercial or business activities.

CHAPTER 13 - INSTALLMENT PLAN FOR INDIVIDUAL

- For individuals who have regular income
- Automatic stay imposed
- Caps on secured and unsecured debt, which adjust periodically
- Trustee appointed
- Debtor proposes repayment plan
- Preserves debtor's non-exempt property
- Classes of claims receive identical treatment
- Debtor remains under court scrutiny for life of plan, usually three to five years
- Payments are made to Chapter 13 trustee who then pays creditors
- Plans can be modified

C. Key Issues in Chapter 11

a. Automatic Stay

The filing of a Chapter 11 petition automatically stays nearly all actions against the debtor or its assets, pursuant to 11 U.S.C. sec. 362(a). That stay provides the breathing room for the debtor which is a central tenet of Chapter 11. Courts take it seriously and will penalize knowing violations. The stay does not just stop collection letters, repossessions, lawsuits and other obvious actions against a debtor. It also can prohibit continuation of an existing action, set-offs, some lien filings (but, importantly not all) and many other activities that can have some effect on the debtor's assets and financial picture.

The automatic stay doesn't just go into effect on a voluntary bankruptcy filing, but applies when creditors file an involuntary petition as well. (Many bankruptcy rights and remedies arise as of

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

the "order for relief" which is simultaneous with a voluntary filing). However, the stay arises with a petition being filed, rather than an order for relief being entered, thus applying to involuntary petitions. Also, it is important to note that, for an involuntary petition, while creditors are stayed, the prospective debtor's property is not under the control of the court.

Key cases regarding the importance and breadth of the automatic stay include:

- *Soares v. Brockton Credit Union (In re Soares)*, 107 F.3d 969 (1st Cir. 1997)
- *Easley v. Pettibone Michigan Corp.*, 990 F.2d 905 (6th Cir. 1993)
- *Job v. Calder (In re Calder)*, 907 F.2d 953 (10th Cir. 1990)
- *Jove Eng'g, Inc. v. IRS*, 92 F.3d 1539 (11th Cir. 1996).
- *Borman v. Raymark Industries.*, 946 F.2d 1031 (3d Cir. 1991).
- *Delpit v. Commissioner*, 18 F.3d 768 (9th Cir. 1994).
- *Computer Communications, Inc. v. Codex Corp. (In re Computer Communications, Inc.)*, 824 F.2d 725 (9th Cir. 1987).

b. Cash Use and DIP Financing

A debtor may use its property postpetition in its ordinary course of business, except that leave of court is required for it to use cash collateral — i.e. cash and receivables on which a creditor has a lien. 11 U.S.C. sec. 363. In other words, the debtor may continue using its real estate, inventory and equipment without permission from the court, but creditors who believe their collateral is diminishing in value may seek protection. However, there will nearly always be a first day motion to use existing cash and accounts receivable, or to borrow money — i.e. a Debtor-In-Possession ("DIP") loan – under 11 U.S.C. sec. 364. Debtors will generally be permitted to use cash within a budget, and the court can permit the debtor to obtain additional financing on a variety of terms. Those orders will likely grant liens to the DIP lender and those liens might be junior to another creditor's existing liens, or they could prime them. For the principal secured creditor in a case, with a lien on cash collateral, negotiation or litigation concerning the extent to which the debtor may use that cash is perhaps the most important event in the early part of the case. If the client has a prepetition lien on some of the debtor's assets, that creditor's lawyer will want to know the terms of the DIP loan, and whether her client's lien is being affected.

Key cases on cash use and DIP financing include:

- *In re Cross Baking Co., Inc.*, 818 F.2d 1027 (1st Cir. 1987).
- *In re Goode*, 235 B.R. 584 (Bankr. E.D. Tex. 1999)
- *In re Keystone Surplus Metals, Inc.*, 445 B.R. 483 (Bankr. E.D. Pa. 2010).
- *Rajala v. Langer (In re Lodge Am., Inc.)*, 239 B.R. 580 (Bankr. D. Kan. 1999).
- *In re Ames Dep't Stores, Inc.*, 115 B.R. 34 (Bankr. S.D.N.Y. 1990).
- *KS Invs. v. T.M. Sweeney & Sons Ltl Servs., Inc. (In re T.M. Sweeney & Sons Ltl Servs., Inc.)*, 131 B.R. 984 (Bankr. N.D. Ill. 1991).

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

- *In re Mosello*, 195 B.R. 277 (Bankr. S.D.N.Y. 1996).
- *MBank Dallas, N.A. v. O'Conner (In re O'Conner)*, 808 F.2d 1393 (10th Cir. 1987).
- *In re Beker Indus. Corp.*, 58 B.R. 725 (Bankr. S.D.N.Y. 1986).

c. Payment of Prepetition Obligations, Including Critical Vendor Payments

Some Chapter 11 cases pay 100% on unsecured prepetition claims, but often the number is much lower, or even nothing. What is paid is usually determined by a plan of reorganization or a sale of assets. Unsecured prepetition claims cannot be paid at the beginning of the case, subject to a few exceptions. Ordinary employee wage claims, within limits, may be paid in the early days of a case by court order, which is nearly always granted. Debtors can seek and get court permission to pay the prepetition claims of "critical vendors" — i.e. those that the debtor says are very important and will not do business with the debtor postpetition without that payment. Generally, the debtor who gets one of these orders negotiates with the vendor to pay part or all of the claim up front in exchange for the vendor's commitment to postpetition terms as good as those offered prepetition. Some bankruptcy courts do not like these orders, but they are often granted, particularly in larger cases.

Another exception is for contracts which the debtor assumes. Absent the creditor's agreement, an executory contract (performance still due on each side) or unexpired lease cannot be assumed by a debtor unless it cures the defaults (i.e. including the prepetition amount owed). Thus, early contract assumption may get a creditor paid its prepetition claim (and often gives some protection against preference claims), but debtors are not required to make the assumption decision until the plan.

- *In re Ionosphere Clubs, Inc.*, 98 B.R. 174 (Bankr. S.D.N.Y. 1989)
- *Armstrong World Indus., Inc. v. James A. Phillips, Inc. (In re James A. Phillips, Inc.)*, 29 B.R. 391 (S.D.N.Y. 1983).
- *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2d Cir. 1983).

d. Lease and Contract Assumption and Rejection

Debtors may generally assume or reject leases and executory contracts (those with performance still due on each side) under 11 U.S.C. sec. 365.

Debtors who wish to assume a contract must cure prepetition defaults that are capable of cure, provide adequate assurance of future performance and then are obligated to perform the contract as written. Debtors who want to assume contracts and then assign them (for instance, to the buyer of its assets), must also provide adequate assurance that the buyer will be able to perform. Debtors must assume or reject a contract as a whole – they cannot cherry-pick portions of the contract for assumption while rejecting others. In complex multiple-document

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

ALFA International
The Global Legal Network
Local Relationships Worldwide

transactions, there can be disputes over what constitutes a single contract or not. As described above, assumption of a contract can provide some protection against preference claims. Provisions in a contract that have the effect of preventing assignment of the contract are generally enforceable unless they operate solely as anti-assignment provisions.

Debtors have a lower bar for rejecting leases and contracts – they have an almost unfettered right to do so, based on their business judgment. (The reverse is not true – the non-debtor party can terminate the contract based on the bankruptcy filing only in special circumstances, generally involving forward and commodity contracts and certain financial instruments.) Rejection is a breach, but does not necessarily terminate the contract. Counterparties can file claims for the damages arising from rejection (but those for future rents are capped). The Code includes some special protections for tenants of a lease rejected by the Debtor (they can maintain possession) and for IP licensees of a Debtor licensor (they may be able to continue use of the license. 11 U.S.C. Sec. 365(h) and (n).

- *Mission Prod. Holdings v. Tempnology, LLC*, 139 S. Ct. 1652 (2019).
- *Lewis Bros. Bakeries v. Interstate Brands Corp. (In re Interstate Bakeries Corp.)*, 751 F.3d 955 (8th Cir. 2014).
- *In re Trans World Airlines, Inc.*, 261 B.R. 103 (Bankr. D. Del. 2001).
- *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303 (5th Cir. 1985).
- *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608 (1st Cir. 1995).
- *In re Fleming Cos.*, 499 F.3d 300 (3d Cir. 2007).

e. Postpetition Vendor Sales - Forcing Vendors to Ship and Protecting Those Obligations

Many vendors presume that, if the Debtor is in default, they can halt or pause their own performance. However, if there is a contract and it was unexpired at the petition date (even if the Debtor was in default), many Debtors will argue that the vendor must continue complying with the contract – i.e. continuing to ship goods and supply services. The Debtors will allege that it is a violation of the automatic stay for the vendor to decline further performance. However, vendors do have the ability to ask the court to protect them against extending further credit post petition by seeking an adequate protection order. Often these issues are resolved by negotiation, and the protection might include COD shipments, critical vendor status (discussed above), credit limits and shortened payment terms, among other protections.

- *In re Collins & Aikman Corp.*, 384 B.R. 751 (Bankr. E.D. Mich. 2008).
- *In re Jartran, Inc.*, 732 F.2d 584 (7th Cir. 1984).
- *Beneke Co. v. Economy Lodging Sys. (In re Economy Lodging Sys.)*, 234 B.R. 691 (B.A.P. 6th Cir. 1999).

f. Proofs of Claim

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

In a bankruptcy case, especially Chapter 11, it is important for creditors to timely file Proofs of Claim. In a Chapter 11 proceeding, the date to file a proof of claim will be set by the court whether in the Notice of Commencement – 341 Notice and/or in a separate Notice of the Deadline to File a Claim. The bankruptcy rules do have a period of time to file a proof of claim in a Chapter 7, 12 or 13 case, which is 70 days after the filing of bankruptcy or the date of conversion to a Chapter 12 or a Chapter 13. When filing the proof of claim, it is important to attach the underlying documentation that substantiates the claim, whether it be invoices, promissory note, mortgage, security agreement, UCC-1 financing statement, state court judgment and the like. An exhibit can also be prepared that details the calculation of the amount of the claim especially if there is pre-petition interest, attorney fees or other cost in the claim amount. The failure to timely file a proof of claim may result in the creditor's claim either being disallowed in full or not being allowed to share in the distribution in the plan but only be able to share in any surplus funds after the payment of all other timely filed proofs of claim. It is important that when a creditor gets the Notice of Commencement of a bankruptcy case that counsel be quickly contacted to insure the timely filing of the proof of claim with the proper paperwork. Finally, if a proof of claim is objected to, it is again important to contact counsel to review the objection and to either negotiate a resolution or to file a formal response to the objection to claim. If an objection to claim is not responded to, the claim may be disallowed in part or in full as well.

There is a special category of unsecured claims for goods provided to the debtor within 20 days of bankruptcy, §503(b)(9). These claims are treated like administrative claims in that they are highly likely to be paid in the Chapter 11. It is important to review the creditors invoice to see if in fact goods were provided to the debtor within 20 days of the filing of the bankruptcy to file a §503(b)(9) claim for priority payment.

Key cases on proofs of claim include:

- *In re Alexander*, 435 F. App'x 563 (7th Cir. 2011).
- *In re Batista-Sanechez*, 502 B.R. 227 (Bankr. N.D. Ill. 2013).
- *Hong Kong & Shanghai Banking Corp., Ltd. v. Simon (In re Simon)*, 153 F.3d 991 (9th Cir. 1998).
- *Langenkamp v. Culp*, 498 U.S. 42 (1990).
- *In re marchFIRST, Inc.*, 573 F.3d 414 (7th Cir. 2009).
- *Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. P'ship*, 507 U.S. 380 (1993).

g. Sale of the Business in Chapter 11

One of the common procedures in a Chapter 11 case, in fact becoming the predominant procedure, is to sell the assets of the business in the bankruptcy proceeding. This is a called §363 Sale. Some have claimed that Chapter 11 should be renamed Chapter 3, after §363. The debtor will quite frankly file a motion to sell substantially all of its assets either to a stalking horse bidder

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

with an asset purchase agreement or may have an open auction and bidding procedure if there is no stalking horse bidder. However, most of the time the Chapter 11 cases will have a stalking horse bidder with an asset purchase agreement. The sale may be for substantially all of the debtor's assets and may include the assumption of certain executory contracts and unexpired leases and reject many other executory contracts and unexpired leases. The sale will be free and clear of all claims, liens, interest and encumbrances with those interest attaching in the order of their priority to the claims; first being paid secured claims, usually with a carve out amount of money for the professionals, then to the unsecured creditors. There will be a procedure and process for soliciting higher and better bids for the assets and there could well be a spirited auction of the assets. The purchaser will also obtain certain protections, such as being deemed a good faith purchaser with no successor liability and that unless the sale is appealed with a stay pending appeal, an appeal may well be moot if the sale has been consummated. These sale procedure are extremely common, especially in the larger Chapter 11 cases given the traditional plan of reorganization is becoming rarer as cases evolve. If the creditor is the holder of an executory contract or an unexpired lease, it is extremely important to carefully review the schedule of contracts and leases to determine if your contract or lease is proposed to be assumed and then assigned to make sure that the amount of the "cure" is correct. The debtor in possession must provide that the holder of the executory contract or unexpired lease that is being assumed or assigned must have its defaults cured. Many times, the cure amount will be substantially lower than what the creditor believes is the correct cure amount. In the event that the creditor is also a secured creditor having a security interest in some of the assets of the debtor, it is important to review the sale procedures and asset purchase agreement to make sure that the creditors interest is protected and preserved in the proceeds of the sale. If the holder of the executory contract or unexpired lease is not assumed, then the creditor can file a proof of claim for the rejection damages. The time period, however, to file the proof of claim for rejection damages is very quick and counsel should be consulted to make sure that the deadline is not missed.

- *In re Culp*, 545 B.R. 827 (D. Del. 2016).
- *Sollow v. PPI Enters. (U.S.), Inc. (In re PPI Enters. (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003).
- *Sandy Ridge Dev. Corp. v. Louisiana Nat'l Bank (In re Sandy Ridge Dev. Corp.)*, 881 F.2d 1346 (5th Cir. 1989).

h. Plans and Disclosure Statements

The debtor in possession in a Chapter 11 has the exclusive right to file a plan and disclosure statement for 120 days after the filing of the bankruptcy case. The period of time, called the exclusive period, can be extended for cause up to 18 months after the filing of the bankruptcy. The exclusive period, however, can be shortened upon motion of creditors and/or the unsecured creditors committee. The disclosure statement is designed to provide information to the creditors as to the background of the debtor, its operations and its proposed restructuring The

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

plan details the treatment that each creditor or creditor class is to receive in the plan. The plan can either be a reorganization plan where the debtor restructures its debts and continues to operate or can be a plan of liquidation where the debtor winds down it operations, sometimes through a liquidating trust. Some courts have allowed the debtor to combine the plan and the disclosure statement into one document; that way the time for confirmation is shortened to have the debtors plan of reorganization or liquidation implemented quicker. Creditors in Chapter 11 are able to vote on the plan and depending upon the class of the creditor, creditors can block a plan from being confirmed under certain circumstances. The debtor must comply with provisions of the bankruptcy code to have its plan confirmed. There are a number of cases that have dealt with releasing non-debtor parties from liability through Chapter 11 plans. Such procedure is closely scrutinized by the courts. Creditors need to closely review the plans to determine what is the proposed treatment and whether to object to the plan. The plan can be confirmed over the objection of the creditors and is binding upon all creditors, whether they voted for the plan or not. The plan may also contain certain injunctions against taking action against the debtor or non-debtor third parties which must be closely scrutinized as well. In a reorganization plan, there may be a term of years which the creditors would be paid some percentage of their debt. In addition in Chapter 11 cases, there is a robust industry of debt purchasing whereby debt purchasers will contact creditors to buy their claims at a discount. Those debt purchase contracts need to be closely reviewed, not only for the amount that is being offered to be purchased, but also the terms of potential repayment to the debt purchaser in the event that the claim is objected to by the debtor.

- *In re Ferretti*, 128 B.R. 16 (Bankr. D.N.H. 1991).
- *In re Texas Extrusion Corp.*, 844 F.2d 1142 (5th Cir. 1988).
- *In re Charles St. African Methodist Episcopal Church of Boston*, 499 B.R. 66 (Bankr. E.D. Mass. 2013).

i. Avoidance Actions

The debtor in possession has in its arsenal a number of powerful tools to avoid transactions invoking both the bankruptcy code and state law. The avoidance actions are found in Chapter 5 of the Code. The two main avoidance actions are preferences and avoidable transfers. A preference is a transfer made to a creditor within 90 days of bankruptcy (insider, one year) which enabled the creditor to receive more than the creditor would have received through a Chapter 7 bankruptcy. There are a number of defenses to a preference action including ordinary course of business and new value. It is important that when a preference action is served, there is only at most one month to answer the complaint; otherwise a default will be taken and a judgment entered. Service of an avoidance action is a nationwide service by first class mail (unless you are a bank or credit union). It is extremely important to provide to your counsel a copy of the preference lawsuit as soon as it is served.

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

The second main type of avoidance is avoidable or fraudulent transfer. There are two main types of avoidable transfers, constructive and actual. A constructive avoidable transfer is a transfer of an asset of the debtor for less than fair value while the debtor was insolvent or rendered insolvent by the transfer. An actual fraudulent transfer is where the debtor intended with the transfer to hinder, delay or defraud its creditors. The time period to file an avoidable transfer is the longer of two years after the petition is filed or the time allowed under state law to file a fraudulent transfer. So by way of example, if your state statute of limitation is four years, the debtor in possession then has four years to file the avoidance action. The statute of limitation to file a preference action however is two years.

The third type of avoidance action is the debtor in possession stands in the shoes of a hypothetical bona fide purchaser for value. With this power, the debtor in possession can avoid certain transfers, such as improperly recorded mortgages and UCC statements. One of the common problems with UCC-1 financing statement recordings is that the name of the borrower debtor may be off just a little. If the UCC financing statement is not findable using the state's search logic, even though the name is close, close only counts in horseshoes. Similar with a mortgage, if the mortgage is not recorded correctly or attaches to the wrong property, the mortgage interest may be avoidable. The time period to file this type of action is two years.

The debtor in possession can also avoid transfers of property that occur post-petition without court authority. The time period to file this cause of action is two years.

It is crucial that if you are served with any lawsuit to avoid any type of transaction, counsel must be involved immediately to protect the creditors interest and to file appropriate pleadings.

- *Boberschmidt v. Society Nat'l Bank (In re Jones)*, 226 F.3d 917 (7th Cir. 2000).
- *Cox v. Momar Inc. (In re Affiliated Foods Southwest Inc.)*, 750 F.3d 714 (8th Cir. 2014).
- *Kroh Bros. Equity Co. v. Continental Constr. Engineers, Inc. (In re Kroh Bros. Dev. Co.)*, 930 F.2d 648 (8th Cir. 1991).
- *Boyer v. Crown Stock Dist., Inc.*, 587 F.3d 787 (7th Cir. 2009).
- *Pension Transfer Corp. v. Beneficiaries under the Third Amendment to Fruehauf Trailer Corp. Retirement Plan No. 003 (In re Fuehauf Trailer Corp.)*, 444 F.3d 203 (3d. Cir. 2006).

D. SCOTUS Decisions in 2020

a. ***Ritzen Grp., Inc. v. Jackson Masonry, LLC*, 140 S. Ct. 582 (2020). Jurisdiction**

Issue: Does a creditor's motion for relief from an automatic stay initiate a distinct proceeding terminating in a final, appealable order when the bankruptcy court rules dispositively on the motion?

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

SCOTUS Holding: The adjudication of a motion for relief from an automatic stay forms a discrete procedural unit within the broader bankruptcy case. That unit yields a final, appealable order when the bankruptcy court unreservedly grants or denies relief.

Facts And Procedural Background

Prior to the bankruptcy filing, Ritzen filed suit against Debtor Jackson Masonry claiming breach of a contract to sell property. After Jackson Masonry sought bankruptcy relief, Ritzen moved for relief from stay to proceed with the state-court litigation. The bankruptcy court denied the motion for relief, and Ritzen initiated an adversary proceeding to litigate the breach of contract claims, which resulted in a ruling in favor of Jackson Masonry. Ritzen then filed two appeals, but only one of which is of note here: whether the denial of the stay relief motion, which was entered months before Ritzen's appeal was filed, was appropriate. Jackson Masonry successfully argued in the district court that the appeal of the stay-relief order was not timely filed, and Ritzen appealed to the Sixth Circuit Court of Appeals.

The key issue before the court was whether the bankruptcy court's stay-relief order was final. As provided in 28 U.S.C. § 158(a), a party may appeal "final judgments, orders, and decrees … entered in cases and proceedings" by a bankruptcy court, along with certain interlocutory orders and decrees not at issue here. Under Federal Rule of Bankruptcy Procedure 8002(a), final orders must be appealed within fourteen days of entry. Thus, if the stay-relief order was final upon entry but the appeal was not filed for months thereafter, the appellate court has no jurisdiction to hear the matter.

The Court of Appeals for the Sixth Circuit affirmed the District Court's dispositions. As to the timeliness of the first notice of appeal, the Court of Appeals rendered this determination: Adjudication of Ritzen's motion for relief from the automatic stay qualified as a discrete "proceeding," commencing with the filing of the motion, followed by procedural steps, and culminating in a "[dispositive] decision based on the application of a legal standard." In re Jackson Masonry, LLC, 906 F. 3d 494, 499-500 (2018). The 14-day appeal clock, the Court of Appeals therefore concluded, ran from the order denying the motion to lift the stay, a disposition "(1) entered in a proceeding and (2) final[ly] terminating that proceeding." Id. at 499 (alterations omitted). Id. at 587-88.

The Unanimous Opinion

The Court, consistent with the Sixth Circuit's holding, concluded that the appropriate "proceeding" for purposes of determining finality is the stay relief adjudication. Id. A motion for relief from stay "initiates a discrete procedural sequence, including notice and a hearing, and the creditor's qualification for relief turns on the statutory standard, i.e., 'cause' or the presence of specified conditions." Id. This procedural sequence is "a procedural unit anterior to, and separate from, claim-resolution proceedings," which may be governed by state substantive law.

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

Id. Under Bullard, the Court concluded, "a discrete dispute of this kind constitutes an independent 'proceeding' within the meaning of 28 U.S.C. § 158(a)." Id. The Court notes that its conclusion is consistent with the statutory text, as Section 157(b)(2), a provision preceding Section 158(a), provides a list of "core proceedings" arising in bankruptcy cases, and lists motions to terminate, annul, or modify the automatic stay in a separate subsection from the "allowance or disallowance of claims against the estate." Id. (citing 11 U.S.C. § 157(b)(2)(B) and (G)). This statutory scheme, though not dispositive, provides a "'textual clue' that Congress viewed adjudication of stay-relief motions as 'proceedings' distinct from claim adjudication." 205 L. Ed. 2d at 428 (citing Bullard, 135 S. Ct. at 1693). Because the Court finds the appropriate "proceeding" for determining finality within the meaning of Section 158(a) is the adjudication of Ritzen's motion for relief of the automatic stay, the Court held that the bankruptcy court's order conclusively denying that motion is final. Id.

Final Thoughts

Following Ritzen, bankruptcy practitioners would be wise to file an appeal within the 14-day time period prescribed by Bankruptcy Rule 8002(a) whenever there is any doubt respecting the finality of a bankruptcy court's order. A litigant that fails to timely file an appeal risks forfeiting that right, as Ritzen learned. It remains to be seen whether, in the wake of Ritzen, there will be an uptick in the number of appeals filed as practitioners await further clarity from courts on what else constitutes a discrete procedural unit for purposes of the finality determination under Section 158(a).

b. ***Roman Catholic Archdiocese of San Juan, Puerto Rico v. Acevedo Feliciano*, 140 S. Ct. 696 (2020). Jurisdiction**

Issue: Are the Catholic organizations/entities identified as defendants liable for continuing to pay pensions?

SCOTUS Holding: A Puerto Rico trial court had no jurisdiction to issue payment and seizure orders after a pension benefits proceeding was removed to federal district court but before the proceeding was remanded back to the Puerto Rico court; thus the orders are void. Remanded.

A nunc pro tunc order is only used "to reflect the reality of what has already occurred."

Facts and Procedural Background

The Catholic Church in Puerto Rico created a trust to administer a pension plan for employees of Catholic schools called the Pension Plan for Employees of Catholic Schools Trust ("Trust"). Id. at *697. Active and retired employees sued in the Puerto Rico Court of First Instance alleging that the Trust eliminated the employees' pension benefits. Id. The Court of First Instance denied a preliminary injunction requiring the payment of benefits, but the Puerto Rico Supreme Court reversed in favor of the employees, finding that if the "if the Trust did not have the necessary

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

funds to meet its obligations, the participating employers would be obligated to pay." Id. And the Supreme Court remanded to the Court of First Instance to determine which defendants in the case had "legal personalities" such that they would be responsible for continuing to pay the pensions. Id. at *698.

After remand to the Court of First Instance, the Archdiocese removed the case to the United States District Court for the District of Puerto Rico. Id. at *700. The Archdiocese contended that the Trust filed for Chapter 11 bankruptcy, and the litigation between the Catholic Church and the employees was sufficiently related to the bankruptcy to give rise to federal jurisdiction. But the Bankruptcy Court dismissed the Trust's bankruptcy proceeding on March 13, 2018. Id. Thus, ostensibly terminating the basis for removal of the suit against the church entities.

The Court of First Instance then issued its order directing the "Roman Catholic and Apostolic Church in Puerto Rico" to make payments to the employees in accordance with the pension plan. Id. Ten days later, the Court issued a second order requiring the Church to deposit $4.7 million in a court account within 24 hours. Id. at *698. The next day, the Court issued a third order, requiring the sheriff to "seize assets and moneys of . . . the Holy Roman Catholic and Apostolic Church, and any of its dependencies, that are located in Puerto Rico." Id. It was not until nearly five months later, on August 20, 2018, that the District Court entered its order remanding the case to the Court of First Instance. Id. at *700. The August 20, 2018 order, however, provided that it was nunc pro tunc to March 13, 2018—the date the Trust's bankruptcy was dismissed. Id.

Several appeals followed. Ultimately, the Puerto Rico Supreme Court, relying on the Treaty of Paris of 1898, found that all church entities in Puerto Rico—including schools and parishes—are liable for the debts of their related Catholic institutions. Id. at *698. The Catholic Church in Puerto Rico filed a petition for certiorari in January 2019, contending that rulings by the Puerto Rico Supreme Court violated the Free Exercise and Establishment Clauses of the First Amendment. Id. at *699. The Supreme Court granted the petition and ruled on Puerto Rico's lack of jurisdiction without reaching the merits of the First Amendment argument. Id. at *699.

Per Curiam Opinion

The Supreme Court determined that the Puerto Rico Court of First Instance did not have jurisdiction when it entered the collection orders before remand. Id. at *701. Therefore, the district court's entry of the remand order nun pro tunc did not retroactively create jurisdiction and the collection orders were void. Id.

The Supreme Court began its analysis by discussing the jurisdictional effect of removing a case to federal court. The Supreme Court observed that once a notice of removal is filed, "the State court shall proceed no further unless and until the case is remanded." Id. at *700 (quoting 28 U. S. C. §1446(d)). Thus, the state court "los[es] all jurisdiction over the case, and, being without

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

jurisdiction, its subsequent proceedings and judgment [are] not … simply erroneous, but absolutely void." Id. (citing Kern v. Huidekoper, 103 U. S. 485, 493 (1881)).

While the District Court remanded the case to the Court of First Instance by way of a nunc pro tunc judgment stating that the order "shall be effective as of March 13, 2018," the Supreme Court found that federal courts may issue nunc pro tunc orders only to "reflect[ ] the reality" of what has already occurred. Id. at *700–01 (quoting Missouri v. Jenkins, 495 U.S. 33, 49, 110 S.Ct. 1651, 109 L.Ed.2d 31 (1990)). In other words, the Supreme Court stated that "[s]uch a decree presupposes a decree allowed, or ordered, but not entered, through inadvertence of the court." Id. at *701 (quoting Cuebas y Arredondo v. Cuebas y Arredondo, 223 U.S. 376, 390, 32 S.Ct. 277, 56 L.Ed. 476 (1912)). The Supreme Court reasoned that a court "cannot make the record what it is not" by creating facts that never occurred. Id. Because nothing occurred in the District Court case on March 13, 2018, the case remained in federal court until the District Court on August 20, 2018 rendered its decision on the motion to remand, which was pending before it. Id. Thus, the Supreme Court held that all actions taken by the Court of First Instance before remand including the payment and seizure orders were void.

Final Thoughts

The practical import of this opinion can be vast or constrained to its set of facts. The main issue for most practitioners will be that the state court had no jurisdiction after the removal, so any actions taken were void ab initio. The effect of the language regarding retroactive orders may have the most impact on bankruptcy practice. To be sure, the Supreme Court did not ban all nunc pro tunc orders. But it is important to keep in mind when requesting this form of relief that a court "cannot make the record what it is not."

c. *Rodriguez v. FDIC*, 140 S. Ct. 713 (2020). Choice of Law

Issue: Whether a parent corporation or its subsidiary owns a tax refund during bankruptcy proceedings.

SCOTUS Holding: State law supplies the rule of decision when determining which entity in a corporate group owns a tax refund during a bankruptcy proceeding. Corporate affiliates can freely decide, in a tax allocation agreement, the beneficiary of a tax refund among a corporate group filing a consolidated tax return, even if the allocation does not align with the company which created the tax losses and even when one or more of the corporate affiliates is in a bankruptcy case or an FDIC receivership.

Facts and Procedural Background

The Rodriguez opinion resolved a circuit split regarding whether state law or federal law supplies the rule of decision when determining, in the absence of a tax allocation agreement (or in the

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

case of a dispute concerning the interpretation of such an agreement), which entity in a corporate group owns a tax refund issued to the group in respect of its consolidated tax return.

United Western Bank ("UWB") entered receivership under the stewardship of the FDIC. Id. at *3. The UWB's parent, United Western Bancorp, Inc. ("Bancorp") was forced into bankruptcy and a trustee was appointed. Id. Consistent with IRS regulations, the IRS issued a $4 million tax refund to the corporate group without allocating the refund amongst the various entities. Id. The FDIC, on behalf of the UWB, and the trustee, on behalf of Bancorp, each claimed ownership of the tax refund, and the parties litigated that dispute in Bancorp's bankruptcy case. Id. at *4. The bankruptcy court determined the Bob Richards Rule, a creation of federal common law, did not apply because the parties had a tax allocation agreement, and concluded that under that agreement, Bancorp had title to the tax refund, making it property of Bancorp's bankruptcy estate under Bankruptcy Code Section 541, notwithstanding that the refund was generated on account of the UWB's losses. United Western Bancorp, Inc. v. Fed. Deposit Ins. Corp. ("In re United Western Bancorp, Inc."), 558 B.R. 409, 434, 437 (Bankr. D. Colo. 2016).

The FDIC appealed on behalf of UWB and the district court reversed. In In re United Western Bancorp, Inc., 574 B.R. 876, 878 (D. Colo. 2017), the district court determined that, under Colorado law, the tax allocation agreement was ambiguous regarding ownership of the refund, and that, in accordance with the terms of the contract, that ambiguity should be resolved in favor of UWB. Id. at 894 (citing a provision in the contract requiring ambiguity be resolved in favor of the UWB, with a view to effectuating the intent of the contract, to provide an equitable allocation of tax liability among Bancorp and UWB). Finding that Bancorp held only bare legal title to the refund, whereas UWB that sustained the losses held equitable title, the district court concluded that the refund belonged to UWB and was not property of Bancorp's estate. Id. at 895.

On appeal, the Tenth Circuit affirmed the district court's ruling. In In re United Western Bancorp, Inc., 914 F.3d 1262, 1264 (10th Cir. 2019), the Tenth Circuit determined that "[f]ederal common law," here, the Bob Richards Rule, "provides a framework for resolving this issue." Id. at 1269. Applying the Bob Richards Rule and Tenth Circuit precedent (Barnes v. Harris, 783 F.3d 1185 (10th Cir. 2015)), the court determined it "must look to the terms of the [tax allocation] Agreement and, taking into account Colorado case law, decide whether it unambiguously addresses how tax refunds are to be handled and, if so, whether it purports to deviate from the general rule in Barnes and Bob Richards." Id. at 1270. In accordance with the contract provision requiring that ambiguities be resolved in favor of UWB, the court "conclude[d] that the Agreement creates an agency relationship between [Bancorp] and UWB, and that, consequently, the Agreement's intended treatment of tax refunds does not differ from the general rule outlined in Barnes and Bob Richards." Id. at 1274. The Tenth Circuit affirmed the district court's ruling below that the tax refund belonged to UWB, that generated the losses giving rise to the refund, and was not part of Bancorp's estate. Id.

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

The Unanimous Opinion

The Supreme Court held that state law, not federal law, supplies the rule of decision when determining which entity in a corporate group owns a tax refund issued in respect of the group's consolidated tax return. Rodriguez v. Fed. Deposit Ins. Corp., No. 18-1269, 2020 U.S. LEXIS 1364, at *10 (2020). Rodriguez resolves a circuit split by overruling a judicially crafted federal rule—the "Bob Richards rule"—applied by the Tenth Circuit, on the basis that "[c]orporations are generally creatures of state law, and state law is well equipped to handle disputes involving corporate property rights." Id. at *9 (internal quotation marks and citation omitted).

The Court explained that "[j]udicial lawmaking in the form of federal common law plays a necessarily modest role under a Constitution that vests the federal government's 'legislative Powers' in Congress and reserves most other regulatory authority to the States." Id. at *7. Indeed, as the Court "has long recognized, 'Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law.'" Id. (quoting Butner v. United States, 440 U.S. 48, 54 (1979)). The Court rejects the FDIC's suggestion that "[e]ven if the Tenth Circuit's reliance on Bob Richards's analytical framework was mistaken," the Court should nevertheless affirm because "the court of appeals proceeding to consult applicable state law." Id. at *9. The Court explains "we did not take this case to decide how this case should be resolved under state law," rather, "[w]e took this case only to underscore the care federal courts should exercise before taking up an invitation to try their hand at common lawmaking." Id. at *10.

Accordingly, the Court vacated and remanded, indicating that the court below may consider on remand whether the case might yield the same or a different result without reliance on the now defunct Bob Richards rule. Id.

Final Thoughts

After Rodriguez, bankruptcy practitioners should be careful of asserting positions based on federal common law rules without a strong showing that federal common lawmaking is strictly "necessary to protect uniquely federal interests." See id. at *7. In vindicating state law over federal common law, the Rodriguez decision reaffirms the Court's tone that state law governs the determination of property rights in the assets of a debtor's estate. Id. at *9).

d. ***Financial Oversight and Management Board for Puerto Rico v. Aurelius Investment, LLC*, 140 S. Ct. 1649 (2020). Appointment Power**

Issue: Did presidential appointments of the members of the Financial Oversight and Management Board (the "Board") for Puerto Rico, without Senate confirmation, violate the Appointments Clause of the U.S. Constitution?

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

SCOTUS Holding: No. While the Appointments Clause constrains the President's power to appoint, even as to officers with powers and duties related to Puerto Rico, members of the Financial Oversight and Management Board are not "Officers of the United States" within the meaning of the Appointments Clause.

Facts and Procedural Background

In 2015, Puerto Rico was facing a debt crisis exacerbated by several governmental deficits and a recession. Puerto Rico's governor announced that Puerto Rico was in a "death spiral" and could not pay its debts. In response, President Obama signed the Puerto Rico Oversight Management and Economic Stability Act of 2016 (PROMESA) into law. PROMESA gave the President authority to appoint a Financial oversight and Management Board that would exercise control over Puerto Rico's budget and negotiate the restructuring of Puerto Rico's indebtedness.

Among the Board's powers, PROMESA authorized the Board to file for bankruptcy on behalf of Puerto Rico and represent Puerto Rico in bankruptcy proceedings. A number of Creditors and elected officials filed civil actions challenging the President's authority to appoint the Board members. These civil actions alleged that the Appointments Clause of the U.S. Constitution Required senate confirmation for the appointment of high-level federal officers and that the Board members fit within the scope of the Appointments Clause.

The federal district court for the district of Puerto Rico ruled against those challenging the President's authority. The district court found that the Board was an instrumentality of Puerto Rico's government established pursuant to Congress's plenary power under the Territorial Clause of the U.S. Constitution and that the Board's members were not "Officers of the United States." The First Circuit Court of Appeals reversed the district court's decision, holding that the Territorial Clause does not supersede the application of the Appointments Clause and that the Board members were "Officers of the United States."

Decision

The Supreme Court explained that the Appointments Clause restrains appointments of all "Officers of the United States," including those in relation to Puerto Rico. But, the Court explained, the Appointments Clause does not restrict the appointment of local officers that Congress vests with primarily local duties. If Congress primarily vests an appointment with local duties and powers, then the appointee is not an "Officer of the United States." Congress vested the Board with broad investigatory powers: it can administer oaths, issue subpoenas, take evidence, and demand data from governments and creditors. But these powers are backed by Puerto Rico, not federal law.

The Court found that the Board members were entrusted primarily with local powers and duties. For example, the Board's duties are to represent Puerto Rico and its interests in bankruptcy proceedings, not to represent the interests of the United States. Furthermore, the Court

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

explained that "[t]he [bankruptcy] proceedings take place in federal court; but the same is true of all persons or entities who seek bankruptcy protection. The Board here acts as a local government that might take precisely the same actions." Furthermore, the Court acknowledged that the bankruptcy proceedings could have a broad nation-wide effect, but explained that "the same might be said of any major municipal, or even corporate, bankruptcy."

Final Thoughts

This decision affirms the President's power to appoint territorial officials with primarily local powers and duties. Such territorial officials may be vested with broad investigatory powers and may have authority to represent their local territorial government in bankruptcy proceedings. However, the test for what constitutes "primarily local" duties and powers remains unclear. Finally, it appears that the impact of this decision is primarily limited to the District of Columbia and U.S. territories because the Court supported its analysis by relying on two provisions of the Constitution which give Congress authority to legislate for the District of Columbia and U.S. territories. The Court explained that both the text and structure of the Constitution and history indicate that when Congress has created local offices using this power, these officials have been regarded as exercising local power rather than federal power.

E. Small Business Chapter 11

The Small Business Reorganization Act of 2019 ("SBRA") may provide a simpler and cheaper avenue to reorganize under the Bankruptcy Code. The SBRA, which is referred to as subchapter V of chapter 11, is intended to mitigate obstacles of traditional Chapter 11 reorganizations including high administrative costs, difficult confirmation requirements, and significant creditor influence over the confirmation process. It became effective February 19, 2020 and is available to most small businesses who meet the debt caps discussed below.

The Act's purpose is explained by House Committee on the Judiciary Report No. 116-54, which states that, "[s]mall business chapter 11 cases continue to encounter difficulty in successfully reorganizing," and that the SBRA, "allows [small business] debtors to file bankruptcy in a timely, cost-effective manner, and hopefully allows them to remain in business," which "not only benefits the owners but employees, suppliers, customers, and others who rely on that business."

a. Court Decisions Recognize that SBRA's Purpose is to Make Small Business Reorganization Cheaper And Easier

In *In re Penland Heating & Air Conditioning, Inc.*, No. 20-01795, 2020 LEXIS Bankr. 1550 (Bankr. E.D.N.C. June 11, 2020), a North Carolina bankruptcy court examined and recognized the SBRA's purpose to make small business reorganization cheaper and easier when it questioned the role of expensive and zealous counsel in such cases. The court held that subchapter V trustees (automatically appointed in SBRA cases) are not permitted to hire counsel as a matter of course and should carefully consider whether to do so because they will not be compensated if the

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

hired counsel is overzealous or undertakes unnecessary or duplicative services. The court reasoned that "authorizing a Subchapter V trustee to employ professionals, including oneself as counsel, routinely and without specific justification or purpose is contrary to the intent and purpose of the SBRA," which is to streamline the reorganization process for small businesses.

b. Recent Court Decisions Highlight Important Differences Between Subchapter V And Traditional Chapter 11 Reorganization

Five of the most important distinctions between reorganization under the new subchapter V and a traditional chapter 11 reorganization are that the SBRA "(1) modifies confirmation requirements; (2) provides for participation of a trustee . . . while the debtor remains in possession of assets and operates the business as a debtor in possession; (3) changes several administrative and procedural rules; . . . (4) alters the rules for the debtor's discharge and the definition of property of the estate with regard to property an individual debtor acquires postpetition and postpetition earnings;" and (5) permits only the debtor to file a plan or plan modification. Paul W. Bonapfel, A Guide to the Small Business Reorganization Act of 2019, 93 Am. Bankr. L.J. 571, 576 (2019).

Important among these distinctions, a court may confirm a plan under subchapter V even if all creditor classes reject it and may do so without adhering to the "absolute priority rule," which, generally speaking, requires a chapter 11 plan "to adhere to the order of priority entitlements against the debtor's assets between classes of unsecured claims and equity interests under applicable non-bankruptcy law" and ensures that creditors are paid in full before equity owners retain anything. Charles Jordan Tabb, The Law of Bankruptcy 1166-67 (2d ed. 2009). In place of the absolute priority rule, the new subchapter V requires the debtor to pay disposable income to creditors for a period set by the court of three-to-five years. 11 U.S.C. § 1191(c)(2). In *In re Patel*, No. 09-39791-C-11, 2020 Bankr. LEXIS 2904 (Bankr. E.D. Cal. Oct. 15, 2020), a California bankruptcy court recently clarified this requirement, holding that "disposable income" means actual disposable income and that the definition includes revenue from all sources. The court also explained that the debtor owed a duty to account to the creditors concerning disposable income on a periodic basis.

c. Courts Interpret Who Qualifies To Restructure Under The New Subchapter V

To qualify for relief under subchapter V, a debtor must: (1) be a debtor under chapter 11; (2) be a "small business debtor" under section 101(51D) of the bankruptcy code; and (3) must elect to have subchapter V apply to its case. 8 Collier on Bankruptcy P 1180.02 (16th Ed. 2020). Section 101(51D) defines a "small business debtor" as "a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning single asset real estate) that has aggregate noncontingent liquidated secured and unsecured debts . . . in an amount not more than $2,725,625 . . . no less than 50 percent of which arose from the commercial or business

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

activities of the debtor . . . ." The Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") temporarily raises the debt limit from $2,725,625 to $7,500,000. *In re 305 Petroleum, Inc.*, Nos. 20-11593-JDW, 20-11594-JDW, 2020 Bankr. LEXIS 3008, *5 n. 5 (Bankr. N.D. Miss. Oct. 27, 2020). The debt limit does not, however, include contingent and unliquidated claims. See, e.g., *In re Parking Mgmt.*, No. 20-15026, 2020 Bankr. LEXIS 2309 (Bankr D. Md. Aug. 28, 2020) (holding that lease rejection claims against the debtor and its obligation to repay Paycheck Protection funds are excluded from the debt limit determination because they are contingent and, in the case of the PPP loan, unliquidated).

The definition also does not include: (1) "any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than" $7,500,000, (2) "any debtor that is a corporation subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 . . .;" or (3) any debtor that is an "issuer" as defined by the Securities Exchange Act of 1934.

Three recent decisions have further clarified these qualifications. A South Carolina bankruptcy court recently ruled that it is unnecessary for a debtor to be conducting business when filing its petition to qualify. *In re Wright*, No. 20-01035-HB Chapter 11, 2020 Bankr. LEXIS 1240 (Bankr. D.S.C. Apr. 27, 2020). The court explained that "[a]lthough the brief legislative history of the SBRA indicates it was intended to improve the ability of small businesses to reorganize and ultimately remain in business, nothing therein, or in the language of the definition of a small business debtor, limits application to debtors currently engaged in business or commercial activities." Id. at *7 (internal footnote omitted) (emphasis in original). Similarly, a Louisiana bankruptcy court held that personal guarantees of a defunct business's debts are enough to satisfy the qualifications. *In re Blanchard*, No. 19-12440, 2020 Bankr. LEXIS 1909 (Bankr. E.D. La. Jul. 16, 2020).

Finally, a Mississippi bankruptcy court found that the debt of the debtor's affiliate — even where the affiliate did not itself qualify for subchapter V reorganization — is properly aggregated into the total debt to be weighed against the $7.5 million debt ceiling. *In re 305 Petroleum, Inc.*, 2020 Bankr. LEXIS 3008. The court explained that "Congress made clear that a small business debtor cannot be a member of a group of affiliates whose aggregate debt exceeds $7,500,000," and that the affiliate's "status as a single asset real estate debtor has no impact on its status as an affiliate of the jointly administered debtors." Id. at *7-8.

d. Courts Support Conversion and Redesignation From Existing Cases

The first published opinion to interpret the SBRA held that an existing chapter 11 debtor does not need to ask permission to convert its bankruptcy to subchapter V. *In re Progressive Solutions*, Inc., 615 B.R. 894 (Bankr. C.D. Cal. 2020); see also In re Trepetin, 617 B.R. 841 (Bankr. D. Md. 2020) (holding that converting from a chapter 7 to a subchapter V is also permissible). The court explained that "an amendment to a Bankruptcy Petition can be made at any time as a matter of

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

course at any time before the case is closed" and the debtor may thereby redesignate under subchapter V. Id. at 900-01. The court explained, however, that "[i]f any vested rights of a debtor or any other party in interest would be in jeopardy, this Court concedes that rescheduling would likely be a violation of due process." Id. at 899-900. The court also noted that the due process violation could be waived by the creditor holding vested rights if the creditor approved of a redesignation. Id.

Two noteworthy decisions have permitted redesignation notwithstanding the violation of procedural requirements. *In re Ventura*, 615 B.R. 1 (Bankr. E.D.N.Y. 2020); *In re Twin Pines, LLC*, No. 19-10295-j11, 2020 Bankr. LEXIS 1217 (Bankr. D.N.M. Apr. 30, 2020). The decisions allowed debtors in chapter 11 reorganization to convert to subchapter V despite the subchapter's otherwise applicable procedural requirements, including the requirement for a status conference within sixty days of the order for relief (i.e. the date of a voluntary bankruptcy filing) and for the debtor to file a plan within ninety days from the order for relief. However, at least one court has held that the violation of such procedural requirements may prevent a debtor from converting its case. *In re Seven Stars on the Hudson Corp.*, 618 B.R. 333 (Bankr. S.D. Fla. 2020).

Two noteworthy cases have addressed the effect that redesignation to subchapter V has on existing creditors' committees. A California bankruptcy court held that redesignation may dissolve an existing committee. *In re Bonert*, No. 2:19-bk-20836-ER, 2020 Bankr. LEXIS 1783 (Bankr. C.D. Cal. Jun. 3, 2020). The court explained that a committee could survive redesignation if it showed "cause" to do so, which requires the committee to "demonstrate that its continued existence will improve recoveries to creditors, will assist in the prompt resolution of [the] case, and is necessary to provide effective oversight of the Debtors." Id. at *9. However, another California bankruptcy court declined to allow the debtor to dismiss its reorganization and immediately refile under subchapter V in a case where counsel for the creditors' committee had not yet been paid. *In re Slidebelts, Inc.*, No. 2019-25064-A-11, 2020 Bankr. LEXIS 1777 (Bankr. E.D. Cal. Jul. 6, 2020).

Finally, an Oklahoma bankruptcy court recently held that debtor misconduct may be a bar to conversion. The court declined to extend the automatic stay in a converted case where the debtors paid counsel without authorization and spent estate assets that should have been in escrow. *In re Crilly*, No. 20-11637-SAH, 2020 Bankr. LEXIS 1718 (Bankr. W.D. Okla. Jun. 30, 2020). This misconduct depleted the estate's value by $50,000. The Court also reasoned that confirmation was unlikely and the conversion's purpose was to delay creditors' recovery.

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

"TWO SIDES OF THE SAME COIN: UNDERSTANDING THE COSTS OF THE BANKRUPTCY TRANSFORMATION"

A Walk Through Chapter 11, Hypothetically Speaking…

The Debtor:

Almost overnight, Between The Sheets Mattress Company, Inc. ("Between The Sheets") rapidly expanded its presence throughout the country, growing from two stores in central Iowa to a presence in more than 300 locations. At its climax, Between The Sheets boasted sales of its mattresses, satin sheets, and leather accessories of over $100 million a year. Its attractive sales reps were handsomely paid bonuses for their services, whatever that entailed.

Between The Sheets found its success by using some, ahem, more than questionable practices and choices of marketing its products. The rumor mills were ablaze. Allegations squirrelled across social media that the company executives and leasing agents had gotten kick backs in exchange for expensive and above market lease terms. After all, who doesn't need a mattress store on every corner? And beyond that, a quick glimpse of the company's risqué Instagram revealed that Between The Sheets employed many former models to provide "at-home demonstrations" of the quality of its product line of mattresses, silk sheets, and leather accessories.

They say politics makes for strange bedfellows. So can marketing. Unfortunately, its high-flying expansion activities soon crashed and burned when it unwittingly got caught up in the #MeToo Era. First, it became publicly known that one of the company's high profile clients included a financier and socialite now accused of some very unsavory behavior with the opposite sex. Then, a key endorser of the products, Johnny B. Moviestar was publicly alleged to be auditioning new talent using the Company's products. The company never anticipated being tarnished and sullied in the press by being tied, at least metaphorically speaking, to the likes of Socialite and Moviestar. The company received significant blowback in the press when photos surfaced showing its products prominently on display in Socialite's various properties, and when Moviestar was front page news for his talent-development efforts. Between The Sheets' slumping sales were also drilled by an exploding market of mattresses now being purchased over the internet and delivered directly to people's homes.

Sales were not the only area where Between The Sheets failed to perform. While Between The Sheets claimed that it was a Delaware corporation, in actuality, it was incorporated in the Isle of Man.

Creditors:

The company's finances were as wild as its marketing. While Between The Sheets had a traditional line of credit promissory note of $30 million at its primary lender, Redundant National Bank, N.A., a national bank, it also had a number of other hard money lenders and cash merchant accounts. Between The Sheets also appeared that it had over-leveraged its finances by pledging the same collateral to multiple lenders, who were unaware of such collateral ménage à trois.

When Redundant called its note due upon default (invoking not only a payment default, but also the insecurity clause in its loan documents), Between The Sheets experienced a severe cash crunch. After all, its leasing efforts had drained the cash from the company for years. So, Between The Sheets Made the hard choice: it began to hoard its cash and screw, er… not pay its vendors.

The company's vendors were already uneasy and nervous after the news broke regarding possible malfeasance associated with the lurid "home demonstrations" and connections to unsavory socialites and moviestars. The vendors knew that they had to respond. They did what they could: change the terms of credit given to Between The Sheets, as they changed the company's orders from "net-30" to "cash on delivery" or "cash in advance," which further caused a cash crunch for the company.

Scenario:
Between The Sheets found itself in a bind. The company's Board of Directors removed its maligned CEO, President, Treasurer, and General Counsel. The new C-suite collectively decided that the best course forward to right the ship is to seek Chapter 11 protection. Tomorrow, it intends to file its petition to preemptively stop its landlords from filing eviction actions on the 300 locations and to stop Redundant National Bank from proceeding with a foreclosure sale of the inventory, IP and other assets. Complicating matters, certain vendors have asserted a security interest in the merchandise that they had delivered and also asserted the right to reclaim their goods. The cash merchants entered confessions of judgment and began garnishing accounts.

Suppose your firm has been retained, with a large retainer secured, of course, as outside counsel for Between The Sheets. Where do you go from here? How do you advise the new management team during the long, dark road ahead?

What about Redundant National or one of the various trade creditors? If you were representing them, how could you best protect their interests? And, assuming that the new management team is able to turn things around, is the long-term relationship with Between The Sheets worth saving?

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

BANKRUPTCY QUICK REFERENCE GUIDE 2021

BANKRUPTCY COURT JURISDICTION

The bankruptcy court has jurisdiction over all property of the debtor wherever located in the world. The filing of a U.S. corporation does not necessarily place into bankruptcy its foreign subsidiaries. However, U.S. bankruptcy courts can prevent creditors of the foreign subsidiaries from taking action that would harm the U.S. corporation in bankruptcy. All property of the debtor prior to bankruptcy becomes part of the bankruptcy estate upon filing.

AUTOMATIC STAY

Upon the filing of bankruptcy an automatic stay is put into place. The automatic stay is an injunction stopping virtually all actions against the debtor to recover property, sue the debtor or cancel contracts with the debtor.

FIRST DAY ORDERS

In many bankruptcy cases the bankruptcy court will enter a number of orders on the first day or so in the bankruptcy case. These so-called first day orders may provide for use of cash collateral or the obtaining of new financing, continuation of pre-bankruptcy bank accounts and honor shipping orders, continuance of insurance policies and payment of wages among other forms of relief.

DEBTOR IN POSSESSION

Upon filing a Chapter 11, the debtor company becomes a debtor-in-possession and remains in control of its assets. The debtor in possession is a fiduciary for the creditors and has powers as a bankruptcy trustee.

CHAPTER 11 TRUSTEE

Upon the motion of the creditors or the United States Trustee, who administers Chapter 11 cases through the U.S. Department of Justice, the court can appoint an independent party as a trustee to operate the Chapter 11 company. A trustee can be appointed if there is fraud or mismanagement by the principals of the debtor operating the debtor company.

CREDITOR COMMITTEE

One or more committees of creditors can be appointed by the Office of the United States Trustee to represent the interests of the creditors. In large Chapter 11 cases there may be more than one creditor committee formed to represent different interests of creditors such as trade creditors, shareholders and employees.

CRITICAL SUPPLIER PROTECTION

A current trend is to have the bankruptcy court determine that certain suppliers are critical to the reorganization of the debtor. The debtor can seek permission from the bankruptcy court to provide for payment to the critical suppliers on their pre-bankruptcy debt. Normally, a debtor may not pay a creditor after the filing of bankruptcy for receivables owing prior to bankruptcy, except in the context of a plan of reorganization.

REJECTION/ASSUMPTION OF CONTRACTS

The debtor-in-possession (or trustee) can petition the court to reject contracts that are burdensome to the estate. It can also seek court permission to assume and assign contracts.

RECLAIMING GOODS

A creditor that has supplied goods to the debtor prior to bankruptcy can, through the proper procedures, petition the bankruptcy court to recover the goods supplied to the debtor shortly before the filing of bankruptcy. However, an existing lien on inventory should trump a reclamation right.

SET-OFF

The bankruptcy code recognizes the right to set off mutual debts between a debtor and a creditor. However, a creditor must seek permission from the bankruptcy court to setoff debts.

PREFERENCE RECOVERIES

The debtor in possession (or trustee) has a wide array of claims it can assert against creditors. Among the claims the debtor in possession can assert are claims to recover payments made by the debtor within 90 days of bankruptcy to a creditor. Such lawsuits are called preferences. There are certain defenses that a creditor can raise with the bankruptcy court to avoid having to return funds received from a debtor, such as ordinary course of business and new value.

PLAN OF REORGANIZATION

The debtor-in-possession is provided an opportunity to propose a plan of reorganization to repay its creditors some or all of its money over a period of time. Creditors may vote on a plan, but it can also be approved by the court even if few creditors vote for it. Creditors can also file plans of reorganization, either upon court permission or after the exclusive period of time expires for a debtor to propose such a plan.

© COPYRIGHT 2021 ALFA INTERNATIONAL GLOBAL LEGAL NETWORK, INC. ALL RIGHTS RESERVED.

CHAPTER 7 – LIQUIDATION

- Frequently used by individuals, not businesses
- Automatic stay imposed
- Means test to avoid abusive filings by individuals
- Trustee appointed to liquidate assets and distribute to creditors
- Debts can be reaffirmed
- Debtor can exempt certain assets from liquidation
- May need to file proof of claim if notified to do so
- Process is generally fast
- Debtor receives a discharge

CHAPTER 11 – REORGANIZATION

- For business that wants to continue operating or sell as a going concern
- Automatic stay imposed
- Debtor usually remains in possession of property (debtor-in-possession)
- Cash collateral order needed to continue operations if a lien on cash and receivables
- No exempt property for businesses
- Debtor will propose a Chapter 11 plan within 120 days of filing
- Creditors vote on plan or object to plan
- Plan may cram down secured debt to value of property
- Unsecured creditors committee may be formed
- Motions for relief from automatic stay are common and frequently granted in single asset real estate cases

CHAPTER 13 - INSTALLMENT PLAN FOR INDIVIDUAL

- For individuals who have regular income
- Automatic stay imposed
- Caps on secured and unsecured debt, which adjust periodically
- Trustee appointed
- Debtor proposes repayment plan
- Preserves debtor’s non-exempt property
- Classes of claims receive identical treatment
- Debtor remains under court scrutiny for life of plan, usually three to five years
- Payments are made to Chapter 13 trustee who then pays creditors
- Plans can be modified

AUTHORED BY:

Lea Pauley Goff
STOLL KEENON OGDEN PLLC
Louisville, Kentucky
lea.goff@skofirm.com

David A. Lerner
PLUNKETT COONEY, PC
Bloomfield Hills, Michigan
dlerner@plunkettcooney.com

*This Quick Reference Guide was created in conjunction with the 2021 International Client Seminar to accompany the panel hosted by its authors.