ALFA International
THE GLOBAL LEGAL NETWORK

2022 Business Litigation Seminar

September 8-10, 2022

So, They Threatened Bankruptcy: Bankruptcy Balderdash & Adversary Proceedings[1]

Chuck Kunz
Moderator
MORRIS JAMES LLP
Wilmington, DE
ckunz@morrisjames.com

Denise Dell-Powell
DEAN MEAD
Orlando, FL
ddpowell@deanmead.com

BANKRUPTCY BASICS[2]

CHAPTER 7 (LIQUIDATION); 11 U.S.C. §§ 101(41), 109(B).

Available for: Individuals
Partnerships
Corporations
Other business entities.

In a Chapter 7 bankruptcy case, a bankruptcy trustee (appointed by the United States Trustee) gathers and sells the debtor's nonexempt assets and uses the proceeds of such assets to pay holders of claims (creditors) in accordance with the provisions of the Bankruptcy Code. Part of the debtor's property may be subject to liens and mortgages that pledge the property to other creditors. In addition, the Bankruptcy Code will allow the debtor to keep certain "exempt" property; but the trustee will liquidate the debtor's remaining assets.

One of the primary purposes of bankruptcy is to discharge certain debts to give an honest individual debtor a "fresh start." The debtor has no liability for discharged debts. In a chapter 7 case, however, a discharge is only available to individual debtors, not to partnerships or corporations.

Filing a petition under chapter 7 "automatically stays" (stops) most collection actions against the debtor or the debtor's property. 11 U.S.C. § 362. The stay arises by operation of law and requires no judicial action. As long as the stay is in effect, creditors generally may not initiate or continue lawsuits, wage garnishments, or even telephone calls demanding payments. Violation of the automatic stay can subject to the violator to damages, including punitive damages.

CHAPTER 11 (REORGANIZATION OR LIQUIDATION)

Available for: Individuals
Large Entities
Small Businesses/Subchapter V
Single Asset Real Estate

While individuals can file Chapter 11 cases, Chapter 11 is typically used to reorganize a business, which may be a corporation (including LLC), sole proprietorship, or partnership. A corporation exists separate and apart from its owners, the stockholders. The chapter 11 bankruptcy case of a corporation (corporation as debtor) does not put the personal assets of the stockholders at risk other than the value of their investment in the company's stock. A sole proprietorship (owner as debtor), on the other hand, does not have an identity separate and distinct from its owner(s). Accordingly, a bankruptcy case involving a sole proprietorship includes both the business and personal assets of the owners-debtors. Like a corporation, a partnership exists separate and apart from its partners. In a partnership bankruptcy case (partnership as debtor), however, the partners' personal assets may, in some cases, be used to pay creditors in the bankruptcy case or the partners, themselves, may be forced to file for bankruptcy protection.

Section 1107 of the Bankruptcy Code places the debtor in possession in the position of a fiduciary, with the rights and powers of a chapter 11 trustee, and it requires the debtor to perform all but the investigative functions and duties of a trustee.

The Bankruptcy Code allows small business debtors to file for relief under two different special categories of chapter 11 intended to streamline processes and reduce costs. The first, referred to as a small business case (by definition in 11 U.S.C. § 101(51C)), was created in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), and the second, referred to as subchapter V, was created in 2019 by the Small Business Reorganization Act (SBRA). A debtor may elect either of these two options based on certain eligibility criteria. Both small business and subchapter V cases are treated differently than a traditional chapter 11 case primarily due to accelerated deadlines and the speed with which the plan is confirmed. The two types of cases have different debt limits, defined as the total amount of noncontingent liquidated secured and unsecured debt at the time the debtor files their bankruptcy case.

CHAPTER 13 (INDIVIDUAL REORGANIZATION); 11 U.S.C. § 109(E)

A chapter 13 bankruptcy is also called a wage earner's plan. It enables individuals with regular income to develop a plan to repay all or part of their debts. Under this chapter, debtors propose a repayment plan to make installment payments to creditors over three to five years. Any individual, even if self-employed or operating an unincorporated business, is eligible for chapter 13 relief as long as the individual's unsecured debts are less than $394,725 and secured debts are less than $1,184,200.

Chapter 13 offers individuals a number of advantages over liquidation under chapter 7. Perhaps most significantly, chapter 13 offers individuals an opportunity to save their homes from foreclosure. By filing under this chapter, individuals can stop foreclosure proceedings and may cure delinquent mortgage payments over time.

Another advantage of chapter 13 is that it allows individuals to reschedule secured debts (other than a mortgage for their primary residence) and extend them over the life of the chapter 13 plan. Doing this may lower the payments.

A chapter 13 bankruptcy trustee (appointed by the United States Trustee), administers the case, investigates the financial affairs of the debtor, and acts as disbursing agent, i.e. collecting money from the debtor and disbursing funds to creditors. 11 U.S.C. § 1302(b).

Like with almost any other bankruptcy filing, filing a petition under chapter 13 "automatically stays" (stops) most collection actions against the debtor or the debtor's property. 11 U.S.C. § 362. The stay arises by operation of law and requires no judicial action. As long as the stay is in effect, creditors generally may not initiate or continue lawsuits, wage garnishments, or even telephone calls demanding payments. Violation of the automatic stay can subject to the violator to damages, including punitive damages.

Unless the court grants an extension, the debtor must file a repayment plan with the petition or within 14 days after the petition is filed. Fed. R. Bankr. P. 3015. A plan must be submitted for court approval and must provide for payments of fixed amounts to the trustee on a regular basis, typically biweekly or monthly. The trustee then distributes the funds to creditors according to the terms of the plan, which may offer creditors less than full payment on their claims.

If the debtor wants to keep collateral securing a particular claim, the plan must provide that the holder of the secured claim receive at least the value of the collateral. The plan need not pay unsecured claims in full as long it provides that the debtor will pay all projected "disposable income" over an "applicable commitment period," and as long as unsecured creditors receive at least as much under the plan as they would receive if the debtor's assets were liquidated under chapter 7. 11 U.S.C. § 1325.

A chapter 13 debtor is entitled to a discharge upon completion of all payments under the chapter 13 plan so long as the debtor: (1) certifies (if applicable) that all domestic support obligations that came due prior to making such certification have been paid; (2) has not received a discharge in a prior case filed within a certain time frame (two years for prior chapter 13 cases and four years for prior chapter 7, 11 and 12 cases); and (3) has completed an approved course in financial management (if the U.S. trustee or bankruptcy administrator for the debtor's district has determined that such courses are available to the debtor). 11 U.S.C. § 1328. The court will not enter the discharge, however, until it determines, after notice and a hearing, that there is no reason to believe there is any pending proceeding that might give rise to a limitation on the debtor's homestead exemption. 11 U.S.C. § 1328(h).

The discharge releases the debtor from all debts provided for by the plan or disallowed (under section 502), with limited exceptions. Creditors provided for in full or in part under the chapter 13 plan may no longer initiate or continue any legal or other action against the debtor to collect the discharged obligations.

BANKRUPTCY "PLAYERS":

Debtor – the individual or business entity filing bankruptcy

Debtor-in-Possession – A bankruptcy scenario (usually in chapter 11 case) where the debtor continues to be responsible for running the business during a reorganization

Chapter 7 Trustee – The person or entity responsible for liquidating the debtor's assets; appointed by the US Trustee

Chapter 11 Trustee – The person or entity who can be appointed to operate a chapter 11 debtor's business when the persons who would normally be responsible have acted in bad faith or are actively mismanaging the business.

United States Trustee – Watch dog for the integrity of the bankruptcy process. Runs initial meeting of creditors and appoints members to the Official Committee of Unsecured Creditors. Has standing to be heard on any issue arising during the case.

Official Committee of Unsecured Creditors – a panel of (usually the largest) 3, 5 or 7 unsecured creditors (who are willing to serve) appointed by the US Trustee as fiduciaries for all other unsecured creditors; roles include reviewing debtor's operations, reviewing positions of secured creditors (and possibly challenging liens), and negotiating with the debtor over plans of reorganization or liquidation for the benefit of unsecured creditors. A committee can hire its own counsel and financial advisors. Fees and expenses of counsel and other professionals are paid by the debtor.

Pre-petition Lender/DIP Lender – Can be one and the same; but can be "new money" lenders. Often, a pre-petition secured lender may attempt to "roll-up" prepetition debt into a new loan ("DIP Financing") with priming liens and super-priority administrative expense status in order to protect its prepetition loans from potential deficiencies, or just as leverage under which it will agree to lend into the bankruptcy case. There is a usually a finite time (60-90) days for an official committee of unsecured creditors to commence actions to challenge prepetition liens or other claims against a lender. Almost always, the debtor must waive such claims as a condition to getting the lender to make the DIP loan.

EMERGENCY ISSUES UPON BUSINESS CHAPTER 11 FILINGS:

Automatic Stay – 11 U.S.C. § 362

"When a debtor files for bankruptcy, section 362(a) of the Bankruptcy Code imposes a broad automatic stay." *In re Nortel Networks, Inc.*, 669 F.3d 128, 137 (3d Cir. 2011). The automatic stay is an automatic "existing, statutorily-created injunction" that debtors can enforce by motion when violated. *In re Extraction Oil & Gas, Inc.*, No. 20-11548 (CSS), 2020 WL 7074142, at *4 (Bankr. D. Del. Dec. 3, 2020). The automatic stay prohibits "any act to obtain possession of . . . or to exercise control over property of the estate . . . ." 11 U.S.C. § 362(a)(3).

Debtors' Emergency Relief

When a business files a bankruptcy petition, it submit to the jurisdiction of the bankruptcy court for any relief it seeks. This generally means that a debtor has no authority to seek financing, pay creditors or professionals, pay employees, utilities, and other items necessary to run a business. Accordingly, a debtor may file various motions for relief along with its petition and seek a "first day hearing." Some of the requests for relief that a bankruptcy court may provide on the first day involve the following:

Authority to Pay Employee Wages and Benefits 11 U.S.C. § 507

A debtor with employees will normally seek authority to pay its employees and provide normal benefits in the ordinary course of business. It is not unusual that a debtor may time its bankruptcy filing in order to make sure it can obtain bankruptcy court approval to meet its ordinary payroll schedule. The bankruptcy code limits the amount of wages and other benefits that may be entitled to priority. Currently, that amount is $13,650 earned (but unpaid) in the 180 days prior to the bankruptcy filing.

Use of Cash Collateral – 11 U.S.C § 364

A debtor must have permission to use cash on hand and may seek to use cash collateral. Whether a debtor can obtain the use of cash collateral, as well as how much and for how long, may depend on whether a senior lender has a security interest in the debtor's cash.

DIP Financing – 11 U.S.C. § 364

A debtor may seek additional financing to use during the bankruptcy case. While the debtor can seek unsecured credit, not surprisingly, this is rarely available. It is not unusual for an existing lender to provide debtor-in-possession financing on a senior secured status, sometimes with the lender seeking additional security interests in unencumbered assets, or seeking to prime other lenders with otherwise senior liens.

Insurance

A debtor may seek court approval to make insurance premium payments or continue with certain required types of insurance such as general liability insurance, workers compensation, D&O insurance, automobile, and any other type of insurance that might be applicable to the debtor's business.

Utilities – 11 U.S.C. § 366

Debtors may provide additional security deposits to utilities for the use of utilities during the case.

Retention of Professionals – 11 U.S.C. 327

While not necessarily needed on the first day of the case, it is not unusual for a debtor to file retention applications for its attorneys, financial advisors, investment bankers or other professionals it may require to help administer the case.

Leases 11 U.S.C. § 365

If a debtor has determined to reject certain leases or assume certain leases, one may see a lease rejection or assumption motion on the first day of the case. One might see these types of motions more in retail cases where a debtor has made the determination to rid itself of stores or properties that it does not view as critical to the business going forward. Immediate rejection avoids incurring lease expenses as administrative costs of the bankruptcy.

Critical Vendors/Doctrine of Necessity

A debtor may have unpaid vendors who are deemed critical to the ongoing operations of the debtor's business, and therefore may seek to provide "critical vendor" status to certain of those vendors to assure an ongoing supply of product from those vendors. Relief may be granted on an interim basis in order to allow the Official Committee of Unsecured Creditors (normally appointed about 14-20 days after the start of a case), to weigh in on who is truly critical.

Shipping/Warehousing

A debtor may also seek to provide payments to shippers or warehouses in order to allow for continued access to goods. Shippers and Warehousers may be able to stop shipping mid-transit or may be able to assert liens on goods in their possession to assure payment for their services.

WHAT HAPPENS WHEN SOMEONE THREATENS BANKRUPTCY?

Are you a Creditor? What type? Secured, Unsecured, Priority?

Typically, creditors may fall into many buckets in a bankruptcy case. For example, a creditor who ships or provides goods within 20 days before the bankruptcy may have a priority claim for the value of those goods under Section 503(b)(9). That claim may be unsecured, but the creditor may have priority in payment against other unsecured creditors. It is not unusual for portions of a particular creditor's claim to fall into different priority buckets.

Unsecured – For many unsecured claims, filing a proof of claim may be the least expensive and most efficient recourse. A fully unsecured claim has no collateral or security interest securing the value of the Debtor's obligation.

Secured – In its simplest form, a secured creditor is an individual or entity that issues a loan backed by collateral (also known as a security interest). If the borrower defaults on the loan, the lender may be able to sell the collateral to recoup the value (or a portion) of the loan. Secured claims come in a variety of arrangements, e.g., mortgages and auto loans. Setoff rights may also provide a form of security. Secured claims are generally treated more favorably in bankruptcy cases, but beware the automatic stay which will prevent a secured creditor from exercising rights in the collateral without bankruptcy court approval.

Priority – As outlined in Section 507 of the bankruptcy code, there are certain claims that create a "priority" position in the event of a bankruptcy. This priority position may afford certain categories of creditors better treatment than other creditors. Section 507 includes claims for debts to a spouse or children from court ordered support; administrative expenses of the bankruptcy; unsecured, post-bankruptcy claims in an involuntary case; wage claims of employees and independent contractors (up to $13,650 per claim earned within 180 days before the petition); contributions to employee benefit plans (also subject to the $13,650 limit per employee); claims of farmers and fishermen against debtors operating storage or processing facilities; layaway claims of individual who did not get the item deposited on; and recent income, sales, employment, or gross receipt taxes.

What are you secured in?

A creditor can have a secured claim due to a variety of arrangements, meaning it is not always the case that the creditor has to have a security interest in the underlying thing the debtor has borrowed or has in its possession.

Section 506 of the Bankruptcy Code prescribes a number of rules governing the determination and treatment of secured claims in bankruptcy cases. In general, section 506(a) describes the extent to which an allowed claim is to be treated as a secured claim for purposes of the Code, as well as how a secured claim is to be valued. *See, e.g.*, *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997). In turn, section 506(b) specifies several rules governing the entitlement of the holder of a secured claim to recover postpetition interest, fees, costs and charges. *Compare General Elec. Credit Corp. v. Peltz (In re Flagstaff Foodservice Corp.)*, 762 F.2d 10, (2d Cir. 1985), *and General Elec. Credit Corp. v. Levin & Weintraub (In re Flagstaff Foodservice Corp.)*, 739 F.2d 73 (2d Cir. 1984), *with United States v. Boatmen's First Nat'l Bank*, 5 F.3d 1157 (8th Cir. 1993). Section 506(c) permits the trustee to recover various costs and expenses from a secured creditor's collateral under certain conditions. Finally, section 506(d) sets out a number of special provisions governing the avoidance of liens that secure disallowed claims.

Are you fully secured?

Although obtaining a security interest sounds simple, the Uniform Commercial Code, state law, and certain federal laws (depending on the underlying collateral, e.g., aircraft) impose requirements for "fully securing" a loan. Under the Uniform Commercial Code, a secured party perfects a security interest to ensure that no other party, such as other creditors or a bankruptcy trustee, will claim the same collateral. The details for how to perfect a security interest depend in part on the local jurisdiction where the collateral is located (although there are several carveouts and specific rules to be aware of, depending on the underlying collateral). Generally speaking, to perfect a security interest, an individual must file a financing statement with the appropriate office; possess the collateral; control the collateral; or it is perfected automatically upon attachment of the security interest.

Are you fully unsecured?

As noted above, an unsecured claim is one where payment is not guaranteed by an underlying asset, meaning the creditor has no ability to assert a right of setoff or a lien.

Do you know the value of your collateral? Is the collateral value diminishing?

If the value of your collateral is diminishing, a creditor can petition a court for "adequate protection," which, pursuant to section 361 of the Bankruptcy Code, may be provided in (i) periodic payments; (ii) additional or replacement liens; and (iii) such other relief as will result in the realization of the "indubitable equivalent" of the entity's interest. Note that these are not mandatory methods of adequate protection. Section 361(3) of the bankruptcy code expressly provides that the grant of an administrative priority is *not* an acceptable means of providing adequate protection.

Collateral need not be replaced with an identical type of collateral. The adequacy of protection must be determined on a case-by-case basis. *Resolution Trust Corp. v. Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group, Inc.)*, 16 F.3d 552 (3d Cir. 1994).

Sections 362, 363 and 364 of the Bankruptcy Code permit parties to make a request to the bankruptcy court to determine whether the interest of an entity in property is adequately protected when the trustee or debtor in possession is using, selling, leasing or borrowing against the property, or when the entity is otherwise stayed from enforcing its interest. Parties may agree on appropriate protection, the entity may request particular protection or the trustee or debtor in possession may propose protection that it believes is adequate. Any such agreement is subject to court approval, and in the absence of an agreement, the bankruptcy court must determine, if it determines that protection must be provided, whether in fact the protection is adequate.

Do you have the right to file/perfect a lien/mechanics lien?

Depending on applicable law, a creditor may have the right to assert mechanics or other liens. Section 546(b) may permit post-petition perfection filing and perfection of mechanics liens. Careful attention needs to paid to deadlines for filing liens and commencing actions in order to maintain the lien. Likewise, careful attention needs to be paid to the limitations on such actions by the automatic stay.

Can you assert constitutional liens?

In addition to what are commonly known as "statutory liens," a creditor might have a "constitutional lien." Constitutional liens are self-executing and do not require meeting the direct requirements as prescribed by statutes. The availability of constitutional liens varies greatly from state-to-state, so it is encouraged that you consult your states' rules and regulations. For example, pursuant to Section 37 of Article 16 of the Texas Constitution:

> "Mechanics, artisans, and material men, of every class, shall have a lien upon the buildings and articles made or repaired by them for the value of their labor done thereon, or material furnished therefor, and the Legislature shall provide by law for the speedy and efficient enforcement of said liens."

Will your lien have priority over the pre-petition lender?

A creditor with a lien right or a perfected lien should evaluate whether it has done everything it can to obtain priority over any other lender or lienholder. The lien creditor must also evaluate whether a purported lender with a senior lien actually has a senior lien. This may require an evaluation of UCC filings, or property filings if the collateral is real property.

Are you supplying goods on consignment?

Suppliers consigning goods must be aware that, upon filing bankruptcy, section 362(a)(3) prohibits the consignor from recovering the consigned goods. If the consignor violates this provision, (i) the consignor may be subject to a turnover action under 11 U.S.C §§ 542 or 543 for their return and/or (ii) within 90 days prior to the bankruptcy filing, the consignor may be subject to a preference action under 11 U.S.C. § 547(b) for their return. A consignor who has not documented a proper consignment can be relegated to the status of a general unsecured creditor. However, the consignor may have rights under its consignment agreement and under the Uniform Commercial Code that may help its status. *See, e.g.*, UCC Section 9-103(d).

How much money have you received in the last 90 days?

While creditors must evaluate the likelihood of getting paid, creditors also need to be aware that the debtor can seek to recover *legitimate* payments to the creditor in the 90 days prior to the bankruptcy petition. Thus, creditors who have received payments in the 90 days preceding a debtor's bankruptcy need to be aware of "preference" issues in the bankruptcy code. More specifically, section 547(b) of the bankruptcy code permits a trustee to avoid certain prebankruptcy transfers as preferences.

Section 547(b) sets forth the elements of an avoidable preference as "any transfer of an interest of the debtor in property:

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

  (A) on or within 90 days before the date of the filing of the petition; or

  (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

  (A) the case were a case under chapter 7 [of the bankruptcy code];

  (B) the transfer had not been made; and

  (C) such creditor received payment of such debt to the extent provided by the provisions of [the bankruptcy code].

Have you provided new value/goods in the last 90 days?

If you have provided new value/goods in the last 90 days, you might have a defense to a preference action. Section 547(c)(4) provides that a trustee may not avoid a transfer "to or for the benefit of a creditor, to the extent that, *after* such transfer, such creditor gave new value to or for the benefit of the debtor. . . ."

Did you receive payments during the 90 days "in the ordinary course of business?"

Section 547(c)(2) of the bankruptcy code also provides preference defense to a creditor who received payments in the ordinary course of business. This is a *highly factual* inquiry – much more than the new value defense. Whether payments were made in the ordinary course of business may involve evaluation of the timing of payments, the method of payment, the amount of payments received historically, whether there were demands for payment from the creditor to the debtor, and other factors.

Have you provided new value/goods in the last 20 days? 11 USC § 503(b)(9)

Additionally, creditors who have provided goods in the 20 days preceding a debtor's bankruptcy filing but not yet been paid can qualify for special treatment under the bankruptcy code. Section 503(b)(9) grants such creditors administrative priority status for the value of any goods received by the debtor within 20 days before the bankruptcy *if the goods have been sold to the debtor in the ordinary course of the debtor's business*. Note that many creditors who qualify for section 503(b)(9) administrative priority status may also be able to assert reclamation claims under section 546(c).

Are you bound by a contract with the debtor?

During the period a contract is unassumed and unrejected, the rights, duties and obligations of the debtor are unclear. *See In re Holly's Inc.*, 140 B.R. 1213 (Bankr. W.D. Mich. 1992). However, the contract is generally thought of as remaining "in effect" and the non-debtor parties may be bound to honor it and perform. See *In re Whitcomb & Kelly Mortgage*, 715 F.2d 375 (7th Cir. 1983); *In re Leslie Fay Companies, Inc.*, 166 B.R. 802, 808 (Bankr. S.D.N.Y. 1994).

Are you able to setoff mutually owed obligations? 11 U.S.C. § 553.

The doctrine of setoff allows entities to apply their mutual debts against each other, thus "avoiding the absurdity of making A pay B when B owes A." *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18 (1995). Section 553(a) of the Bankruptcy Code provides that "this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement. . . ."

Is the Debtor paying rent?

Section 365(d)(3) of the Bankruptcy Code provides that a debtor "shall timely perform all the obligations of the debtor . . . arising from and after the order for relief under any expired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1)." This means that a debtor leasing a piece of non-residential real property must timely pay rent and any additional rent as and when it becomes due under the lease after a bankruptcy case until the lease is assumed or rejected.

Are there tenant mix or other restrictions in the lease?

Section 365(b)(3)(C) of the Bankruptcy Code requires a debtor to provide adequate assurance that the assumption or assignment of an unexpired lease *within a shopping center* is subject to provisions such as a radius, location, use, or exclusivity provisions, and will not breach any such provision contained in any other lease, financing agreement, or master agreement in such shopping center.

Do you hold a security deposit or a letter of credit?

Depending on applicable state law and application of the bankruptcy code in your jurisdiction, you may (or may not) be able to draw on a security deposit or letter of credit without seeking relief from the automatic stay. *In re Farm Fresh Supermarkets of Md., Inc., 257 B.R. 770, 772 (Bankr. D. Md. 2001)* (landlord can draw on letter of credit without violating the stay); *but see, e.g. Twist Cap v. Southwest Bank of Tampa*, 1 B.R. 284, 285 (Bankr. M.D. Fla. 1979) (enjoining a draw finding it would effectively convert an unsecured obligation into a secured obligation); and *Wysko Inv. Co. v. Great American Bank*, 131 B.R. 146, 147 (D. Ariz. 1991) (using equitable powers under 11 U.S. C § 105(a) prevent a draw).

Will the debtor attempt to assume your lease or reject your lease?

Pursuant to section 365 of the bankruptcy code, a debtor can assume or reject executory contracts and unexpired leases. A motion to assume or assign an executory contract or unexpired lease shall not be granted by the court within 21 days after the filing of a bankruptcy petition except to avoid immediate and irreparable harm. Fed. R. Bankr. P. 6003. Only a party who is aggrieved has standing to object to the assumption. *In re ANC Rental Corp., Inc.*, 277 B.R. 226 (Bankr. D. Del. 2002) (noncreditor competitor does not have standing to object), *aff'd*, *Hertz Corp. v. ANC Rental Corp.*, 2003 U.S. App. LEXIS 2159 (3d Cir. Jan. 8, 2003) (unpublished).

Section 365(d)(4) of the Bankruptcy Code provides the debtor with a non-residential real property lease with the earlier of, 120 days from the petition date or the date of an order confirming a plan, to determine whether to assume or reject a lease. The bankruptcy court can, for "cause" extend that time for up to 90 days. If the bankruptcy court extends the time for cause, the deadline can be further extended only upon prior written consent of each affected landlord.

A decision to assume or reject a lease may have significant consequences for the estate. If the contract is rejected, the estate will lose any benefit from the contract and will be liable for damages for the breach. Such damages, however, are usually treated as unsecured prepetition claims, and thereby may dilute recoveries to other creditors. If the contract is assumed, any liability thereafter will be an expense of administration, including liability for a later rejection. In addition, before a debtor may assume a lease, the debtor must "cure" all defaults under the lease. *See* 11 U.S.C. § 365(b)(1). This usually means making whole all unpaid amounts under the lease. It may require additional security deposits or effectively bringing the lease back into compliance. The debtor must also provide "adequate assurance of future performance" under the lease. *See* 11 U.S.C. § 365(b)(1)(C). This may require the debtor to show that it will have the ability to pay the obligations under the lease in the future, for example, through access to future financing, increased security deposits, or providing a guarantee of the lease from a solvent third-party.

What claims do you have if the debtor rejects your lease?

Section 502(b)(6) caps a lessor's/landlord's claim for lease rejection damages against a debtor/tenant at the greater of (i) one year's rent or (ii) 15 percent of the remaining term of the lease, not to exceed three years' rent. Section 502(b)(6) is "designed to compensate the landlord for his loss while not permitting a claim so large as to prevent other general unsecured creditors from recovering a dividend from the estate." H.R. Rep. No. 595, 95th Cong., 1st Sess. 353 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 63 (1978).

Are you a utility provider?

Within the first 20 days after commencement of a bankruptcy, a utility may not alter, refuse, or discontinue service to, or discriminate against, a debtor on the basis of filing bankruptcy or the nonpayment of a prepetition debt. Thereafter, except in chapter 11 cases, the utility may only alter, refuse, or discontinue service if the trustee or debtor does not furnish the utility with adequate assurance of future payment, usually but not always in the form of a deposit. However, a utility may not discriminate against a debtor based upon filing bankruptcy or the prepetition debt.

In a Chapter 11 case, a utility can terminate service if the debtor does not provide adequate assurance of future payment within 30 days "satisfactory to the utility." Must be provided even if NOT in default of payment. *499 W. Warren Street Assoc. Ltd. Partnership*, 138 B.R. 363, 366 (Bankr. N.D.N.Y. 1991).

Section 366(c), specifies what can constitute adequate assurance in a chapter 11 case, provides for procedures with respect to adequate assurance in chapter 11, and specifically provides that an administrative expense priority claim does not constitute adequate assurance in a chapter 11 case, and provides for a utility's setoff against a prepetition security deposit in a chapter 11 case.

Do you license intellectual property to or from the debtor?

A licensor of IP to a debtor can find the debtor seeking to assume or reject the IP license under 11 U.S.C. § 365, but there are limitations. As executory contracts, licenses of IP may be assumed and/or assigned under Section 365 of the Bankruptcy Code if either: (1) the license is exclusive; or (2) the owner of the intellectual property authorizes the assignment. *Valley Media,* 279 B.R. at 135-36 (citing *In the Matter of West Elecs., Inc.*, 852 F.2d 79, 82-83 (3d Cir. 1988); *Golden Books*, 269 B.R. 308-09; *Access Beyond Tech., Inc.*, 237 B.R. at 48).

Accordingly, Section 365(c) of the Bankruptcy Code may prevent a debtor who licenses intellectual property from a licensor from assuming and assigning a license to a third party where applicable law permits the licensor from accepting performance from someone else. By way of example, under patent law, only the patent owner can assign a patent so the debtor who is a licensee cannot assign the patent license. There are some nuances to this general rule such as whether the license is exclusive to the debtor or non-exclusive.

A licensee of IP from a debtor also has certain rights. If a debtor seeks to reject a license of IP to a non-debtor, under Section 365(n) of the Bankruptcy Code, the licensee has the option to either consider the license terminated or retain its rights under the license and continue to perform by paying royalties and satisfying other obligations under the license. However, the debtor may not have any further obligation other than to provide the license. For example, the debtor may not have to provide continuing software upgrades or continuing technical support.

It is worth noting that Section 365(n) by its terms would not seem to protect the rights of licensees of trademarks from the debtor. But, in an interesting case from 2019, *Mission Holdings v. Tempnology*, 139 S. Ct. 1652 (2019), the United States Supreme Court held that a debtor's rejection of a trademark license constituted a breach of the license and afforded the licensee the continued right to use the trademark, in effect providing the trademark licensee with similar rights provided by Section 365(n).

Litigation Claimants:

Beware the automatic stay (subject to punitive damages for violation)

The automatic stay is one of the fundamental protections afforded debtors under the bankruptcy laws. *Midlantic Nat'l Bank v. New Jersey Dep't. of Envtl. Prot.,* 474 U.S. 494, 503 (1986) *reh'g denied* 475 U.S. 1090 (1986). The purpose of the automatic stay is "to prevent certain creditors from gaining a preference for their claims against the debtor; to forestall the depletion of the debtor's assets due to legal costs in defending proceedings against it; and, in general, to avoid interference with the orderly liquidation or rehabilitation of the debtor." *St. Croix Condo. Owners v. St. Croix Hotel,* 682 F.2d 446, 448 (3d Cir.1982). "The stay is not meant, however, to be used by a debtor to pursue its creditors, as more litigation is hardly consistent with the concept of a breathing spell for the debtor. Instead, the stay is a shield, not a sword that should help the debtor deal with his bankruptcy for the benefit of himself and his creditors." *In re Residential Capital, LLC,* 2012 WL 3249641, at *2 (Bankr. S.D.N.Y. Aug. 7, 2012) quoting *Sternberg v. Johnston,* 582 F.3d 1114 (9th Cir.2009) (internal quotation marks omitted).

Section 362(k)(1) of the bankruptcy code allows a court, upon a finding of a "willful" violation of the automatic stay to award "actual damages, including costs and attorneys' fees, and, in appropriate circumstances, . . . punitive damages."

Has your litigation case progressed or is it in its infancy?

Depending on the stage of litigation, a litigation claimant might meet the "cause" standard under section 362(d)(1) of the bankruptcy code, permitting relief from the automatic stay. Section 362(d)(1) provides a court with broad discretion, as it is able to terminate, annule, modify, or otherwise condition the automatic stay upon a finding of "cause." A bankruptcy court may find "cause" when it is necessary to permit litigation to be concluded in another forum (*In re Castlerock Properties*, 781 F.2d 159, 15 C.B.C.2d 20 (9th Cir. 1986); to arbitrate a labor claim, *Garland Coal & Mining Co. v. United Mine Workers of Am.*, 778 F.2d 1297 (8th Cir. 1985); or when the action involves the rights of third parties not directly related to the bankruptcy case (See *Pursifull v. Eakin*, 814 F.2d 1501, 16 C.B.C.2d 881 (10th Cir. 1987); *Sovran Bank, N.A. v. Anderson*, 743 F.2d 223, 11 C.B.C.2d 748 (4th Cir. 1984).

If a claimant establishes cause, the burden then shifts to the debtor pursuant to section 362(g) to convince the court that the stay should remain in effect. *See In re 234-6 West 22nd St. Corp.*, 214 B.R. 751, 756 (Bankr. S.D.N.Y. 1997). Courts conduct a "fact intensive, case-by-case balancing test, examining the totality of the circumstances to determine whether sufficient cause exists to lift the stay." *In re The SCO Group, Inc.*, 395 B.R. 852, 857-58 (Bankr. D. Del. 2007).

ADVERSARY PROCEEDINGS – WHAT ARE THEY AND WHAT DO THEY DO?

An adversary proceeding is the bankruptcy equivalent to a lawsuit – started with a complaint. While much of the relief requested by any party, creditor or debtor, in bankruptcy case is presented by motion, pursuant to Fed. R. Bankr. P. 7001, there are certain types of actions that *must* be brought by adversary proceeding.

By way of example, anyone wishing to challenge the validity, extent or priority of a lien claimed by any party must file an adversary proceeding. Fed. R. Bankr. P. 7001(2). Injunctive relief must be sought by adversary proceeding, Fed. R. Bankr. P. 7001(7), as must proceedings to subordinate debt. Fed. R. Bankr. P. 7001(8). Complaints seeking declaratory relief with respect to any actions that fall within Fed. R. Bankr. P. 7001 must be commenced by adversary proceeding.

As noted above, adversary proceedings are commenced with filing of a complaint and service of a summons. Many of the rules in the Federal Rules of Civil Procedure apply in adversary proceedings, such as rules regarding notice pleading, pleading of special matters, motions to dismiss under Fed. R. Civ. P. 12, filing and prosecuting counterclaims and cross claims, discovery, depositions, interrogatories, requests for protection, and the like.

Notably, under Fed. R. Bankr. P. 7001(1), complaints to recover money or property, such as preference actions under section 547 of the bankruptcy code, fraudulent conveyance actions under section 548, and actions to recover judgments in those cases each must be brought as adversary proceedings.

Finally, you may have a right to a jury trial in certain adversary proceedings. It is important to discuss whether to assert a jury right when a complaint or answer is filed. Jury trials will normally not occur in a bankruptcy court. An adversary proceeding may be transferred to the applicable United States District Court if an appropriate jury request is made.

COVID RELATED BANKRUPTCY PROVISIONS

During the Covid pandemic, the Coronavirus Aid, Relief, and Economic Security (CARES) Act was signed into law on March 27, 2020 and included certain temporary amendments to the Bankruptcy Code. Some of those provisions included the following:

- Covid stimulus payments were not subject to any bankruptcy law.
- Debtors in a pending bankruptcy or who had received a discharge could not be denied a mortgage forbearance or protection under the eviction moratorium
- Debtors may have utility service maintained or restored without additional deposits so long as they pay for post-petition service
- Covid related payments including tax rebates and child tax credits are excluded from monthly income.
- Chapter 13 debtors could seek a plan modification based on Covid-related hardship that would extend plan payments for up to 7 years from their first payment.
- Increased the debt limit for Chapter 11 subchapter V cases to $7,500,000.

On March 27, 2021, the Covid-19 Bankruptcy Relief Extension Act of 2021 was signed into law and extended the CARES Act's bankruptcy related amendments for an additional year. The Cares Act was not further extended and all provisions therein sunset on March 27, 2022.

In April 2020, the federal government and other jurisdictions announced moratoria on evictions from rental properties but offered no financial assistance to unpaid landlords. In December 2020, the Consolidated Appropriations Act of 2021 (CAA 2021) was signed into law. It contained several lease and rent-related bankruptcy amendments. Some of the provisions under the CAA provided:

- Protection for landlords from preference claims for payments on non-residential real property leases – subject to limitations that payments cannot be more than they would have been as of March 13, 2020, and cannot include fees, penalties and interest.
- Extended the deadline for debtors in Chapter 11, subchapter V case to have an additional 60 days (total of 120) to pay post-petition rent.

These provisions expire at the end of 2022.

Given that the vast majority of Chapter 11 filings since the pandemic have been filed under Subchapter V, on June 7, 2022, the House passed the Bankruptcy Corrections Act and on June 21, 2022, President Biden signed the Bankruptcy Corrections Act into law. The Act again increased the subchapter V debt limit to $7,500,00 that had expired on March 27, 2022. The bill applied retroactively to include cases filed between March 28, 2022 and June 21, 2022. These provisions expire in two years.

---

1. The matters set forth herein are not legal advice, and nothing may be relied upon in these materials as legal advice. If you have a bankruptcy related issue or matter, you should consult knowledgeable bankruptcy counsel.

2. These summaries of Chapter 7, Chapter 11 and Chapter 13 have been excerpted from guidance provided by the United States Court system at www.uscourts.gov.