

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

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I. Recent Changes to United States Bankruptcy Code

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

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

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

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

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

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

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

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

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

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

II. Overview of Bankruptcy Law

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

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

A. Bankruptcy Code and Rules

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

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

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

B. Types of Bankruptcy Cases

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

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

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

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

III. Immediate Steps to Take When a Bankruptcy is Filed

A. Obtaining Information About the Case

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

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

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

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

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

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

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

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

B. The Automatic Stay

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

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

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

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

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

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

