

## CHAPTER 11 - 101 THE NUTS AND BOLTS OF CHAPTER 11 PRACTICE: A PRIMER

*By Jonathan P. Friedland, Michael L. Bernstein, Prof. George W. Kuney and Prof. John D. Ayer*

### What Every Unsecured Creditor Should Know About Bankruptcy

**Editors' Note:** *This is the ninth of 22 installments that are being published here, with permission from the American Bankruptcy Institute. The series, read consecutively, will give the reader a broad overview of the Chapter 11 bankruptcy process. The installments are chapters from a CD-Rom that is available for purchase for \$20 (\$10 to ABI members) through the ABI. For more information, you can call the ABI at (703) 739-0800 or go to [www.abiworld.org](http://www.abiworld.org). The authors welcome your comments and questions as well, and you may feel free to contact them. Jonathan Friedland is a member of the ABI Board of Directors as well as a member of NACM Oregon.*

Creditors in a bankruptcy case are distinguished by the type of claims they hold. The Bankruptcy Code sets forth a priority scheme for creditors' claims in § 507. In general, creditors whose claims are secured by assets of the estate (a/k/a, secured creditors) are in a superior position, and such claims are outside the gambit of § 507 entirely. Should a Chapter 11 debtor fail in its attempt to reorganize, a secured creditor may generally look to the liquidation of its collateral for payment of its claim (subject to many caveats, which we won't discuss here).

Conversely, all other creditors are dependent upon unencumbered assets of an estate for payment. The priority for payment of these claims is generally as follows: first, spousal support obligations; second, costs of administration (including professional fees and post-petition expenses of operating the debtor's business); third, by a host of unsecured claims that Congress has determined deserve a special high priority (again, see § 507; and also look at § 503); and finally, general unsecured pre-petition obligations. By virtue of their last-in-line position, general unsecured creditors might be viewed as having the most to lose should a Chapter 11 debtor's reorganization fail. It is for this reason that unsecured creditors may be most benefited by a thorough monitoring of the debtor's affairs during the case.

#### Steps to Take Immediately Upon Notice of a Chapter 11 Filing

##### A. First-Day Hearings Can Impact Rights

As discussed in Chapter 2, upon the filing of a debtor's bankruptcy case, the bankruptcy court will typically hear a series of motions filed by the DIP in

which the DIP requests certain authority that it is not automatically entitled to receive under the Bankruptcy Code. In almost all cases, some of these motions include requests to treat certain creditors' claims differently than they might otherwise be treated by the Bankruptcy Code's priority scheme.

Specifically, these "First-Day" motions often include requests for authority to immediately pay certain types of unsecured claims in advance of other unsecured claims. These may include motions to pay pre-petition wages and benefits, critical vendor claims, sales and use taxes, customer obligations, and other obligations depending on the nature of the debtor's business. In most cases, the bankruptcy court will grant these motions where it is shown that the payment of such claims is critical to maintaining the DIP's ongoing operations and going-concern value.

Also, usually included among the first-day motions, is the DIP's request to use cash collateral and/or obtain DIP financing. Once approved, such financing orders typically have a significant impact on the priority scheme for recovery in the bankruptcy case, as they usually involve priming and replacement liens, intricate debt service requirements, and carve-outs for specific types of claims. Chapter 11 of this book discusses Chapter 11 financing.

Unsecured creditors and/or their advisors should read these motions to consider the potential impact on their rights. If appropriate, they should file an objection (or if there isn't enough time to file something, show up at the hearing and object). If you don't protect your rights, you may find that the game is half over just after it starts.

##### B. Obtaining Information About the Case

Upon the initial bankruptcy filing, the DIP is required to serve all known creditors with notice of the commencement of the Chapter 11 case. Beyond that, it is up to the individual creditor to take steps to gather additional information about the case and the treatment of their claims. One way to stay in the loop is to file and serve a request pursuant to Bankruptcy Rule 2002 to be added to the service list

and receive copies of all filings in the bankruptcy case. Although this may open a floodgate of mail, it is traditionally the best way to monitor a case. To cut down on document costs, some courts permit service by email and electronic document retrieval. Depending upon the nature of the claim and your level of technical savvy, this may be a better option as opposed to receiving reams of documents, many of which are irrelevant to protecting a particular creditor's interest.

Another good source of information is the UST. In almost all cases, the UST is briefed by the debtor in advance of the bankruptcy filing, as to the debtor's first-day motions and general intentions for the restructuring. As the 'watchdog' for the debtor's creditors, the UST is often helpful in providing information to creditors that might otherwise be difficult to decipher from the case documents themselves. This is important because, in most cases, many of the first-day motions will have been already heard before you've been able to serve out your Rule 2002 request.

And, not long after the case begins, there will be an opportunity to meet with an attorney for the UST at the initial meeting of creditors. At this meeting, the UST will provide general details regarding the Chapter 11 process and the particular case, and invite your questions. The DIP's counsel will also be on hand at these meetings to provide a case status summary and answer questions as well, and a representative of the debtor will appear and testify under oath.

Finally, the DIP is required to make certain and periodic filings as to its financial status, both as of the petition date and throughout the bankruptcy case. Among these are the DIP's schedule of assets and liabilities and statement of financial affairs. These filings can provide an initial idea as to the DIP's position regarding a particular creditor's claim(s)—the amount the debtor thinks it owes, whether it disputes the claim, etc. It will also list the debtor's assets, secured and unsecured debts, contracts to which the debtor is a party, and lots of other information.

As with general pleadings, these documents can usually be found on the bankruptcy court's website, obtained on an electronic service such as PACER, and/or obtained from the debtor's notice and claims agent. If all else fails, you can usually go to the clerk's office and request a copy. As an additional source of information, the DIP is also required to file monthly operating reports that reflect the debtor's financial position and cash distributions made during the applicable monthly period.

### **C. Serving on the Committee Carries Its Burdens and Its Rewards**

Shortly after the filing of a Chapter 11 case, the UST will hold a meeting (at least in larger cases) to form an official committee of unsecured creditors, and will usually select candidates from the list of the twenty largest unsecured creditors filed by the debtor at the outset of the case.

Once selected, the committee can engage legal counsel and other professionals, such as a financial advisor, to assist it in carrying out its duties. Because the fees for these professionals are paid by the Chapter 11 estate, membership on the Unsecured Creditors' Committee is probably the most cost-effective way for individual unsecured creditors to influence the outcome of a bankruptcy case and protect their interests. The committee has standing to be heard on any issue in the bankruptcy case, and its views tend to be taken seriously by the court.

Of course, along with the benefits of membership, there is some measure of burden. The committee is charged with monitoring and scrutinizing the debtor's Chapter 11 process from start to finish. These obligations often involve numerous meetings, conference calls, and negotiations. This process can be time-consuming, particularly where the case drags on for months or years. Moreover, committee members owe fiduciary duties to all unsecured creditors, not just those creditors with similarly situated interests. This responsibility can be particularly vexing when a committee member is required to balance his own self-interests with the competing interests of other creditors.

A committee member may also be restricted in trading in the debtor's securities. Consequently, like any other financial decision, the decision to serve on the committee should be carefully considered and eventually determined by weighing both the costs and the benefits.

### **D. Understand Reclamation Rights**

As within the nonbankruptcy context, reclamation refers to the right of seller to reclaim goods sold to a debtor while the debtor was insolvent. Bankruptcy Code § 546(c) focuses on that right in the context of a sale that took place immediately before the debtor filed for bankruptcy. In such cases, timing is a critical factor. There is a narrow window within which the seller must act to protect its rights. Specifically, the seller must make a written reclamation demand:

- (i) within 45 days of receipt of the goods by the debtor; or

- (ii) if the 45-day period expires after the commencement of the bankruptcy case, within 20 days after the debtor received the goods.

The right applies to goods received by the debtor, while insolvent, within 45 days prior to the petition date although the seller may have little interest in reclaiming goods sold within the 20 days immediately preceding the petition date, since it is likely to receive full payment for such goods under § 503(b)(9). Note that § 546(c) is not derivative of or dependant upon a state's law, U.C.C. § 2-702 or otherwise; it represents a federal right of reclamation. This right of reclamation is subject to the rights of senior secured lenders, so it may be illusory in those cases where a lender has an undersecured floating inventory lien. Some large commercial debtors will seek to streamline this process by filing a "reclamation procedures motion," requesting that this claim substitution process occur automatically without the need to make individual requests for each reclamation claim.

## **Protecting/Collecting Your Claim**

### **A. Proof of Claims and Bar Dates**

Of all deadlines in a bankruptcy case, the proof of claim bar date is probably the most critical from a creditor's perspective. Missing a bar date is a serious matter. It can cause the claim to be disallowed in a Chapter 11 case or subordinated in a Chapter 7. A late claim may be allowed if the creditor can show "excusable neglect," but no creditor—and especially no lawyer—wants to be in that position.

At some point in the bankruptcy case, the bankruptcy court will enter an order setting the bar date. Shortly thereafter, the debtor is required to send notice of the claims bar date to all known creditors. Attached to the bar date notice will be a sample proof of claim form that can be used for filing your proof of claim. We attach a sample as Appendix 9(a). We also attach the "Committee Notes" as Appendix 9(b). Committee Notes are essentially the legislative history of the official forms. A copy of the general form is also available at <http://www.uscourts.gov/bkforms/official/b10.pdf>.

Given the uncertainty of the postal service, it is not a good idea to just sit back and wait for a bar date notice to arrive. Once you are aware of the bankruptcy case, you should monitor the case docket to identify the bar date for your claim(s). Although the debtor is required to serve all known creditors with actual notice, if the debtor can show that the notice was mailed to any of your business addresses, for example, you'll be faced with a steep

burden to prove that such notice was never actually received. It's best to avoid this argument altogether and simply seek out the bar date on your own without waiting for the notice to arrive.

In Chapter 11 cases, you do not need to file a proof of claim if you agree with the way the debtor listed your claim in its schedules and your claim is not listed as contingent, unliquidated or disputed. However, it is usually a good idea to file a proof of claim in any event, even if your claim is included in the debtor's schedule of unpaid debts. The proof of claim does not need to reflect a liquidated amount in order to be timely filed. The debt can be contingent upon an event to occur in the future and, upon such occurrence, the proof of claim can be amended after the bar date to reflect the liquidated, noncontingent amount due. Unlike requests to file a late proof of claim, amendments to timely filed proofs of claim are freely granted and seldom opposed on timeliness grounds, unless they assert completely new or different claims.

### **B. Monitoring the Debtor's Chapter 11 Plan and Proposed Distribution Timeline**

For most unsecured creditors, payday will come after the Chapter 11 debtor's plan is submitted and approved by the bankruptcy court. Timing for this process varies significantly from case to case, with some debtors filing plans on the first day of the bankruptcy and others not filing until months or even years later. When the plan is eventually filed, you should look to the plan's disclosure statement for the appropriate sections related to distributions for unsecured creditors. Here, you should find information as to how much you can expect to receive and when you can expect to receive it.

The circumstances vary from case to case, the applicable provisions, if ultimately confirmed, have generally been vetted by the committee (and sometimes the UST) with the interests of the general unsecured creditors in mind. If you don't want to wait until confirmation to get paid, you may be able to sell your unsecured claim to a "claim trader." This is a valuable source of liquidity for creditors that are willing to take a discount in exchange for early recovery.

## **Preventive Maintenance**

Counseling creditor clients before a bankruptcy can be a good way to win friends. As the old adage goes: "an ounce of prevention is worth a pound of cure." This saying is quite appropriate in the bankruptcy context where proper preventative steps, if taken pre-petition, can significantly reduce a particular creditor's exposure and improve its standing in a bankruptcy case.

### **A. Avoiding Preference Liability**

Many creditors don't realize it, but in addition to

being left on the hook for their unpaid pre-petition claims, they may also be liable to the debtor's estate for receiving pre-petition preferential payments (a/k/a preferences). As discussed in Chapter 7, the Bankruptcy Code permits a debtor to sue creditors to recover payments made by the debtor shortly before the bankruptcy filing where the payment gave the creditor more than other, similarly situated creditors would get through the bankruptcy process.

The creditor/defendant, however, is not without defenses to these actions. For example, payments will be safe from recovery if they constitute contemporaneous exchanges; payments made in the ordinary course of business; and/or security interests that secure debts that bring new value to the debtor. By keeping accounts current and following ordinary billing practices, you can limit your exposure. Do not allow accounts to slip beyond customary payment terms.

**B. Monitor Debtor's Solvency**

A number of financial services firms provide credit opinions regarding commercial companies and their ability to meet their debts as they become due. If, for instance, your company extends trade credit to a particular customer whose business represents a significant source of your company's revenue, it would be prudent to request such an opinion from time to time.

**C. Establish Protective Payment Alternatives**

As mentioned briefly above, if you become aware that a particular company is a credit risk and may potentially seek bankruptcy protection, you can significantly reduce your exposure by initiating certain payment alternatives that will protect your interests in the event of a filing. These alternatives include obtaining advance payment or cash on delivery (COD) for shipments, establishing an evergreen retainer or cash deposit, obtaining letters of credit, and entering into third-party guarantees.

*Watch for next month's issue—"Priorities."*