

Why You Absolutely Need To Know Something About Bankruptcy

Designed for Those Wittingly or Unwittingly
Drawn into the Bankruptcy Arena

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Why You Absolutely Need To Know Something About Bankruptcy

When someone utters that dreaded “Bankruptcy” word, many people cringe and immediately conjure up images of debtors’ prisons, insolvency, and in the wake of the recent Enron and WorldCom scandals, fraud and deceit. But, bankruptcy is really not such a horrific phenomenon from either the debtor or creditor perspective. Filing a bankruptcy does not necessarily mean an entity is in terminal financial distress. Instead, bankruptcy can be an extremely useful business tool for a company to accomplish a beneficial sale of assets, obtain new financing or achieve a capital restructure. Creditors and potential investors or purchasers can benefit from these aspects of bankruptcy just as much as the entity that files. Even in dire situations where a company is financially troubled, with knowledge and planning the debtor and its creditors can often salvage a decent outcome for all those concerned. But, there are traps for the unwary. These are the reasons why you really need to know something about the “B” word.

“If you find yourself in a hole, the first thing to do is stop digging.”

— WILL ROGERS

Bankruptcy Concepts

“Creditors have better memories than debtors.”

— BENJAMIN FRANKLIN

Bankruptcy is governed by statute, the Bankruptcy Code, effective in 1978, and amended in 1994, and again in 2005. The 2005 amendments known as the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) made sweeping changes for consumer bankruptcies and implemented a few more restrictive provisions for business bankruptcies.

All bankruptcy cases are filed in federal Bankruptcy Court and monitored by a federal Bankruptcy Judge appointed by the Circuit Court of Appeals. Bankruptcy Judges only hear bankruptcy cases. Because it is a specialized area of the law with its own set of courts and rules, bankruptcy seems to maintain a secret aura. In truth, a working knowledge of bankruptcy can be gleaned by knowing a few concepts and a few basic definitions. From a business perspective, understanding just the fundamentals will provide insight into making educated decisions when confronted with a bankruptcy option or problem. Sometimes, it is a matter of knowing the right questions to ask.

Commencement of the Case

All bankruptcy cases are commenced by filing a “petition” with the clerk of the Bankruptcy Court. The petition consists of a two-page document identifying the name of the debtor and the chapter of the Bankruptcy Code under which the debtor will be proceeding. At the time of the filing of the petition, an “Estate” is created and all assets owned by the debtor prior to the filing are considered to be property of that Estate. It is helpful to picture a line being drawn as of the filing date; everything prior is referred to as “pre-petition” and everything after is “post-petition.”

Types of Bankruptcy Cases

Chapter 7 is a straight liquidation. It can be filed by a business entity or an individual. A trustee is immediately appointed randomly from a panel of individuals who have met the Bankruptcy Code qualifications to serve in that capacity. The trustee takes control of the debtor's assets, sells them and distributes the proceeds to creditors. The trustee can operate the debtor's business during the liquidation process. Trustees have full access to the debtor's books and records. BAPCPA requires that all individual debtors must receive credit counseling from an approved agency prior to filing, must receive post-filing financial instruction, and are subject to strict reporting requirements regarding income tax returns and the like. BAPCPA also imposes a "means test" such that a case may be dismissed for abuse if the debtor's disposable income exceeds a certain amount.

Chapter 11 is typically a reorganization case and can be filed by an individual or an entity. As in a Chapter 7, all assets become property of the Estate, but in a Chapter 11, there is no trustee and the debtor remains in possession of the assets. In fact, the debtor is referred to as the "debtor-in-possession" or "DIP." Individuals are subject to many of the reporting and other requirements imposed on Chapter 7 debtors. Businesses typically continue to operate in a Chapter 11 with the goal being to restructure debt or otherwise re-order their financial or corporate structure. Although generally referred to as a reorganization, a DIP can liquidate its assets in a Chapter 11 proceeding and may want to do so believing that the DIP can achieve a higher value than could a Chapter 7 trustee. In certain circumstances, the Bankruptcy Court may appoint a Chapter 11 trustee to take control of the assets if there is a showing that the DIP has committed gross mismanagement, fraud or some other such egregious activity, or is unable to properly conduct its affairs within the confines of the Bankruptcy Code and its various requirements.

Chapter 13 is a reorganization case for individual wage earners. There are limitations on the amount of debt the individual can have in order to be able to file under this Chapter, roughly 300,000 in unsecured debt and \$925,000 in secured debt. The debtor files a reorganization plan in which he or she agrees to repay a certain amount of debt over a three to five-year period. A Chapter 13 trustee is appointed; however, the trustee does not take possession of the debtor's assets. Rather, the trustee's function is to receive and disburse plan payments. Many of the reporting and other requirements imposed on Chapter 7 debtors are also required of Chapter 13 debtors.

Chapters 9 and 12 are specialized chapters of the Bankruptcy Code. Chapter 9 can only be filed by a municipality and Chapter 12 can only be filed by a family farmer.

A Chapter 11 entity or a Chapter 11 individual who conducts business activities other than pure real estate operations may be designated as a "small business" debtor if their liquidated debt is \$2 million or less. Although there are certain reporting requirements, a small business debtor has the advantage of moving the case toward confirmation more quickly and economically.

"At the expiration of sixty days the debt will be discharged by the loss of liberty or life; you, the insolvent debtor, will either be put to death or sold into foreign slavery beyond the Tiber; but, if several creditors are alike obstinate and unrelenting, they might legally dismember your body..."

— THE OLD ROMAN LAW CODE

The Involuntary Petition

Nearly all cases are filed voluntarily by the debtor. However, in certain circumstances, a case can be commenced by an “involuntary petition” filed by a group of creditors. This petition must be filed by three creditors to which the debtor owes unsecured, liquidated, non-contingent debt, and these creditors must allege that the debtor is generally unable to pay its debts as they come due. If the debtor has fewer than 12 creditors, the petition can be filed by a single creditor. The debtor has the right to dispute the involuntary petition on grounds such as that it is regularly paying its debt or that the petitioning creditors are ineligible to participate in the petition (e.g., because their debts are not liquidated or are contingent). Or, the debtor may consent that the bankruptcy case should go forward. For example, if the involuntary petition was filed under Chapter 7, the debtor may agree, but only if the case proceeds under a Chapter 11.

The Automatic Stay (§362)

Immediately upon the filing of the case, an injunction known as the “automatic stay” goes into effect. The automatic stay prevents creditors from proceeding with any action against the debtor such as a foreclosure, collections (including letters and phone calls), perfection of a lien, set-off, lawsuits, and contract terminations (including notices of termination). The policy behind the automatic stay is that the debtor should be entitled to some “breathing room” while assets are marshaled or while a reorganization is being developed. Creditors who violate the automatic stay by proceeding against the interests of the debtor may be subject to monetary sanctions or other penalties.

Certain actions are not subject to the automatic stay, such as some governmental proceedings and tax audits and assessments. Additionally, the automatic stay does not prevent actions against third parties not in bankruptcy (except for certain situations in a Chapter 13 case). Thus, for example, a lender can pursue a guarantor who has not filed bankruptcy even though the entity principally obligated on the debt has filed. In addition, the automatic stay does not prevent collection on a letter of credit or the attachment of a mechanics' lien. A creditor whose action is stayed may file a motion asking the Bankruptcy Court to lift the stay to allow it to proceed with its remedies. Various grounds must be shown. For example, a creditor seeking to foreclose on property may be able to obtain relief from the stay by showing the property does not have equity or that it is declining in value and no payments are being made, or that the property is not useful to the debtor's reorganization.

So-called "single asset" cases are treated somewhat differently. In cases in which the debtor's sole asset is real property, other than residential property with fewer than four units, the debtor is required to file a plan of reorganization within 90 days of filing or make payments to its secured creditors. Otherwise, the stay may be lifted.

BAPCPA has made serial filings by debtors more difficult. If a bankruptcy petition is filed within one year of the dismissal of an earlier bankruptcy, the automatic stay terminates 30 days after the second filing unless the debtor demonstrates that the second filing was in good faith.

“If your sister hits you, don’t hit her back. They always catch the second person.”

— GREAT TRUTHS ABOUT LIFE THAT LITTLE CHILDREN HAVE LEARNED

§363 Sale

Debtors can sell assets while in bankruptcy but generally must obtain Bankruptcy Court approval to do so. This provision of the Bankruptcy Code is a powerful one in that it permits the DIP or a trustee to sell an asset according to the statute “free and clear of liens and other interests.” The result is that property can be sold with few restrictions. The proceeds of the sale remain with the estate, and any secured interest a creditor may have had is transferred to those proceeds. The buyer has little or no risk that the buyer will be confronted with any successor liability. A final sale order from the Bankruptcy Court is virtually impossible to overturn.

All bankruptcy sales are subject to higher and better bids. However, the initial bidder (referred to as the “stalking horse”) which is outbid may be able to obtain reimbursement for amounts spent in due diligence (called a “break-up fee”).

Cash Collateral

If a creditor has a lien on a debtor’s assets which generate cash proceeds (e.g., inventory or revenue-producing real property), those proceeds are referred to as “cash collateral” once bankruptcy is filed. The DIP cannot use cash collateral after the filing unless and until it obtains consent of the creditor or permission from the Bankruptcy Court.

Adequate Protection

This phrase arises several times in a bankruptcy case. It pertains to protecting the interest of a secured creditor whose assets (e.g., equipment) are being used during the bankruptcy. In order to compensate the creditor which has probably not been receiving payments, the Court will require the debtor to provide the creditor with “adequate protection.” This is to prevent the creditor from suffering any decline in the value of its collateral. Adequate protection is usually in the form of monetary payment but can be accomplished by other means such as by providing a lien on unencumbered property.

Preference

A DIP or trustee can recover for the Estate certain payments made to unsecured creditors within ninety days of the filing of the bankruptcy (or one year if the payment was to an insider). These payments are referred to as “preferences.” The purpose is to prevent a debtor from arbitrarily preferring certain creditors immediately before a bankruptcy. Rather, all creditors should share equally in a distribution of the Estate’s assets. For the most part, the targeted payments are ones which are for past debt (e.g., old invoices) and are not within the usual course of the parties’ past dealings.

Typically, at the end of the case, the plaintiff who may be the DIP, a trustee, creditors’ committee, or a liquidating agent, will file a number of lawsuits, called “adversary proceedings,” in the Bankruptcy Court against defendants believed to have received preferential payments. A preference defendant is required to answer and may raise any number of defenses, the most typical being that the payments were made in the ordinary course of business and that the defendant gave new value to the debtor after a preferential payment was made. Although many of these preference suits are settled for less than the full amount of the

payment, the defendant is still faced with the unpalatable predicament of disgorging payments it received pre-petition and then receiving cents on the dollar for its unsecured claim. BAPCPA effectuated certain changes benefiting business defendants including a prohibition on a debtor seeking a preference claim for less than \$5,000 and requiring the suit be brought in the defendant's jurisdiction if the claim is for less than \$10,000.

Plan of Reorganization

In a Chapter 11 proceeding, the case culminates with the Bankruptcy Court's approval of the Plan of Reorganization. This is a document which sets forth how the debtor will restructure and pay its creditors. The Plan will set forth the means for payments such as new financing arrangements or capital contributions, and it will describe the composition of its management. Creditors are classified according to the nature of their claims. Generally, each secured creditor is placed in a separate class and all unsecured creditors are grouped together in one class. Creditors are permitted to vote to accept or reject the Plan. In a class with multiple creditors, acceptance by the class is governed by a formula. Plan approval, called "confirmation," by the Bankruptcy Court creates a binding contract between the debtor and its creditors.

Disclosure Statement

Before the Plan can be sent out to creditors for a vote, the DIP must provide them with a Disclosure Statement approved by the Bankruptcy Court. This is a document which describes the Plan in detail. It will contain a history of the debtor; the factors leading to bankruptcy; the major events in the bankruptcy proceeding; a description of all the creditors and the amount of the claims they are asserting; financial projections; and valuations to support the proposed restructure and payment plan. The DIP will file simultaneously with the Bankruptcy Court its proposed Plan and Disclosure Statement. A hearing on the Disclosure

Statement will be held to determine whether it contains sufficient information to allow creditors to vote on the Plan. Once the Disclosure Statement is approved, the DIP or any of its creditors can solicit creditors to vote in favor of or against the Plan. In small business cases, the hearing on the Disclosure Statement may be combined with the hearing on Plan confirmation which results in a more stream-lined process.

“You can’t hide a piece of broccoli in a glass of milk.”

— GREAT TRUTHS ABOUT LIFE THAT LITTLE CHILDREN HAVE LEARNED

Exclusivity

For the first 120 days after the bankruptcy is filed, only the DIP can file a Plan. That period of time is referred to as the DIP’s “exclusivity.” If the DIP fails to file in that time frame or if the DIP cannot get affirmative votes on the Plan within 180 days after the filing, creditors can file a Plan. The debtor may seek an extension of exclusivity only up to a total of 18 months. In the unusual case where a Chapter 11 trustee is appointed, the trustee can file a Plan at any time. Creditors can request the Bankruptcy Court to terminate or reduce exclusivity in extraordinary circumstances.

Cramdown

In order for a DIP to confirm a Plan, it must obtain the affirmative vote of all the classes of creditors it has proposed. However, the Bankruptcy Code permits the DIP to confirm a Plan even if it does not have all the requisite votes, so long as it can comply with certain specific sections. This process is called “cram-down” because it forces confirmation on creditors who have voted against the Plan.

“If you pick up a starving dog and make him prosperous, he will not bite you; that is the principal difference between a dog and a man.”

— MARK TWAIN

Non-dischargeability

At the conclusion of the bankruptcy case, individuals (not entities) receive what is known as a “discharge.” Essentially, the debtor is no longer liable for any debt that occurred pre-petition. The discharge operates as an injunction and prevents creditors from pursuing collection of any pre-petition debt.

Some debts are not discharged. These include certain taxes, child support, and educational loans. In addition, debts that were incurred as a result of the debtor’s fraud, misrepresentation, breach of fiduciary duty, or malicious conduct are not discharged. A creditor seeking to have its debt declared non-dischargeable because of this type of conduct must file a complaint in the Bankruptcy Court within a specified period of time.

§364 or DIP Financing

A lender is not obligated to continue funding a loan post-petition, and thus a DIP may want to obtain financing. This so-called “DIP financing” may be on an unsecured or secured basis, but it requires Bankruptcy Court approval. Oftentimes, the pre-petition lender wants to extend post-petition credit because it may provide a means to validate its liens or obtain liens on property not already encumbered. In rare instances, the Bankruptcy Court may allow a new lender to provide financing secured by liens superior to an existing lender, a procedure called “priming.”

Executory Leases and Contracts (§365)

The DIP and the trustee have the power to “assume or reject” a lease or a contract. That is to say, the lease or contract can be accepted as written and the parties continue as if the bankruptcy never occurred; or, the lease or contract can be rejected, in which case the agreement is deemed in breach and, practically speaking, the parties’ obligations cease.

An assumed lease or contract can be assigned to a third party. This is a powerful tool in that a lease or contract can be assumed irrespective of language which states the agreement terminates upon the filing of a bankruptcy, or which prevents an assignment. A lease or contract which is rejected results in merely an unsecured damage claim for the non-debtor party.

The debtor is required to assume a commercial real estate lease within 120 days of filing and can only obtain one extension of 90 days unless the landlord consents. This is a significant change effectuated by BAPCPA which requires debtors to determine early in the case which real property leases it will retain. The decision to assume or reject other types of leases and executory contracts generally may be postponed until confirmation.

With respect to real estate leases, the debtor must continue to pay rent post-petition unless and until the lease is rejected. Other leases such as those for equipment may also have payment requirements post-petition.

There are some restrictions on assumption. Mainly, the DIP or trustee is required to cure all arrearages and defaults and show that it can adequately perform in the future. Additionally, the entire contract must be assumed and the debtor cannot pick and choose the provisions it wants to retain or delete. Certain contracts such as for personal services and intellectual property licenses cannot be assumed and assigned.

AUTHOR ERMA BOMBECK ASKED HER HUSBAND:
“What do you think I’d do if I won \$1 million?”
His reply: “You’d spend \$2 million.”

United States Trustee

The United States Trustee’s Office is a division of the Department of Justice and is charged essentially with monitoring Chapter 11 proceedings and Chapter 7 trustees. In a Chapter 11, the DIP is required to meet with a representative of the U.S. Trustee’s Office to abide by certain guidelines, such as opening special DIP bank accounts, filing operating reports with the Bankruptcy Court, and paying a quarterly fee based on disbursements to creditors.

Insider

In general terms, an insider is a related party. A relative, a shareholder in a closely-held business, a member of a limited liability company, or an officer or director of a corporation are all insiders.

Unsecured Creditors’ Committee

In a Chapter 11 case, the United States Trustee’s Office will solicit the debtor’s 20 largest unsecured creditors to voluntarily serve on an unsecured creditors’ committee. If there is enough interest, three to seven creditors will be appointed. The committee represents the interests of all unsecured creditors in the case and acts as a watchdog over the activities in the case. It has the ability to appear in all matters, including those that involve secured creditors or the assumption or rejection of contracts. The committee may hire counsel and other professionals who are typically paid by the DIP. BAPCPA has now required creditor committees to provide information to the entire creditor body. In addition, a small creditor can now petition to be included on the committee if its interests are not being adequately represented.

2004 Exam

Bankruptcy provides the opportunity for liberal discovery into the financial condition, past and present, of the debtor through a deposition known as a 2004 exam. Questioning can be very broad, as can the acquisition of documents.

“Lettin’ the cat outta the bag is a whole lot easier’n putting it back in.”

— WILL ROGERS

§341 Meeting of Creditors

The Bankruptcy Code requires all debtors to appear at what is called the §341 meeting of creditors and to answer questions posed by the United States Trustee’s Office representative who presides over the meeting. Any creditor may also appear and ask the debtor questions. The Bankruptcy Judge is not allowed to participate.

Priority of Distribution

The Bankruptcy Code provides the priority in which creditors are paid in a bankruptcy proceeding. In general, a secured creditor is entitled to recover its collateral, and so, for all practical purposes, it is in first priority. For remaining assets, the priorities are essentially as follows: First, to administrative claimants, including professional fees and expenses which are incurred post-petition. The Bankruptcy Court cannot confirm a Plan unless these are paid at confirmation or the claimants agree to be paid differently. Second, to taxes which were incurred pre-petition. In a Plan, these essentially can be paid over time with interest. Third, to unsecured creditors, and finally, to equity. The general rule is that all claimants on the same level must be treated equally and must be paid in full before the next level can receive payment.

'You can't trust dogs to watch your food.'

— GREAT TRUTHS ABOUT LIFE THAT LITTLE CHILDREN HAVE LEARNED

Proof of Claim

A creditor who claims the debtor owes it money can file a proof of claim with the Bankruptcy Court. This is a two-page document, which sets forth the amount the creditor claims it is owed and the basis for the claim. There are specific deadlines for filing a proof of claim depending on the chapter of the Bankruptcy Code under which the debtor is proceeding. In addition, the Bankruptcy Court may impose a specific “bar date” for filing a proof of claim. Failure to timely file a proof of claim may result in the creditor being denied the right to vote on a plan of reorganization or to receive any distribution of funds from the bankruptcy Estate.

Reclamation

The Bankruptcy Code preserves a commercial seller’s right to reclaim goods shipped to the debtor within a certain number of days of the filing of the bankruptcy. Under BAPCPA, the creditor now receives an administrative priority claim for goods shipped in the ordinary course of business with 20 days prior to the filing.

Bankruptcy-Proofing

Pre-bankruptcy agreements often contain terms to which a party agrees not to file a bankruptcy or which purport to terminate the agreement upon the filing of a bankruptcy. Such language is called an ipso facto clause, and it is rarely enforceable in bankruptcy as it is considered against public policy to restrict a debtor’s right to seek bankruptcy relief.

Bankruptcy Realities

“Never try to teach a pig to sing; it wastes your time and annoys the pig.”

— UNKNOWN

Cases change. Parties change. But, there seems to be a certain set of realities which exists in every bankruptcy case. Knowing (and accepting) these “truisms” makes you much more prepared for the bankruptcy realm. Bankruptcy is fluid. Unlike usual commercial dealings or litigation in which the facts are established, a bankruptcy proceeding is constantly changing. One day the debtor may be seeking to reorganize and the next trying to liquidate a number of its assets.

The Bankruptcy Court is a court with broad jurisdiction. The Court can and will exercise jurisdiction over just about any entity and any matter that relates to the debtor in any fashion.

The Bankruptcy Court is a court of equity. Why does that matter to you as a business person? It matters because it means the results are unpredictable. The Bankruptcy Code is designed to strike a balance between debtor and creditor interests. Nevertheless, as a court of equity, the Bankruptcy Court can wield enormous power in fashioning relief as it sees fit. And, every judge has his or her own unique theory for dealing with the numerous debtor/creditor issues that arise. The caveat is to keep expectations within reason and be prepared to change your position or strategy on a moment’s notice.

Bankruptcy events (e.g., sales and motions) are always an emergency. Not every issue that arises in a bankruptcy proceeding is presented as an emergency, but almost. In a typical Chapter 11, while the debtor may have had weeks to prepare an issue, it will file a motion to be heard on an expedited basis and creditors may be given literally hours to respond. Debtors will almost always be given one bite of the apple. Most judges will follow the unwritten rule that debtors should have at least one opportunity to restructure. But, a debtor that abuses the system will be in trouble. It behooves a debtor to get it right the first time; it behooves a creditor to be patient.

Cash is king. From either side of the aisle, cash wins at the end of the day. From a debtor's perspective, available cash is critical to get through the administrative expenses associated with the Chapter 11, and to weather the period of time cash may not be available from a pre- or post-petition lending source. From a creditor's perspective, a quick resolution of its claim is usually advisable inasmuch as cash is available early on in the case and everyone is optimistic that the debtor will survive. That may not be the situation down the road.

Bankruptcy as an Ally — Why Be a Debtor

“It’s not whether you get knocked down, It’s whether you get up again.”

— VINCE LOMBARDI

The most common use of the Chapter 11 bankruptcy process is one designed to restructure the company’s balance sheet. A company that wants to extend or refinance onerous debt, eliminate burdensome contracts or leases, and/or bring in new capital can generally accomplish these goals by a Chapter 11 filing, which provides these opportunities and a temporary safe haven.

But, Chapter 11 is not just for severely financially distressed entities. There are a myriad of other business reasons for filing a bankruptcy. For example, bankruptcy can be a viable means for clients who want to merge or to alter their capital structures. Similar to the §363 sale situation described previously, the use of bankruptcy in this fashion is a clean way to accomplish this goal because certain liabilities can be disposed of, the end result is blessed with a court order, and SEC requirements may also be eliminated.

Many lenders dealing with financially troubled companies insist on a bankruptcy filing before they will refinance. The bankruptcy gives the lender the opportunity to solidify its lien position or possibly even improve it.

Bankruptcy may be a good alternative for a client who owns some troubled properties and other healthy ones. Structuring a “roll up” and then using the bankruptcy process to propose a long-term solution can provide the necessary and ultimate protection for the distressed properties. As with any business decision, filing a Chapter 11 has its high points and its low points. Certainly, since there is a third party — the bankruptcy judge — participating in every step, there is a natural risk that the case may not evolve exactly as planned. Nevertheless, the main advantages and disadvantages can be identified and assessed.

What Bankruptcy Cannot Do

- ▶ Save money initially. Chapter 11 is an expensive process in terms of professional fees, disbursements to the United States Trustee's Office, and uncompensated time for management to spend on bankruptcy matters.
- ▶ Allow the debtor to hide out. Chapter 11 is often referred to as a fish bowl. The financial reporting requirements are extensive and creditors are given carte blanche ability to explore the debtor's books and records.
- ▶ Restructure a company that has no business. Bankruptcy cannot substitute for the lack of viability. There needs to be a core business to reorganize.
- ▶ Force creditors or customers to continue doing business with the company. Trade vendors, which supply on an open account, can require COD payments and are not required to extend credit terms. Customers without a contractual obligation to purchase from the debtor can simply quit the relationship.

What Bankruptcy Can Do

- ▶ Provide at least a short respite from paying creditors. The automatic stay brings all collection efforts and lawsuits to an immediate halt.
- ▶ Provide an opportunity to alter debt repayment terms.
- ▶ End troublesome contracts or leases. The debtor has a relatively unfettered ability to reject contracts or leases which it no longer believes are in its best interest.

- ▶ Provide time to orchestrate a beneficial sale or liquidation of assets. Without pressure from creditors, the debtor may be able to market and sell assets, which will promote a reorganization or allow an ultimate recovery for creditors.
- ▶ Provide the opportunity to change management and/or restructure the nature of the entity.
- ▶ The key is exploring Chapter 11 options early and developing a beginning and ending strategy. The filing of the bankruptcy petition is a five-minute trip to the clerk's office; the true success of the filing depends on the negotiations and careful planning.

“Adventure is the result of bad planning.”

— HAROLD GADDY

Creditor Strategies — All is Not Necessarily Lost

“Bankruptcy is a legal proceeding in which you put your money in your pants pocket and give your coat to your creditors.”

— JOEY ADAMS

Many companies learn first of a customer’s bankruptcy when they receive the notice of the §341 Meeting of Creditors. And, many react with dismay and figure there is no hope of recovery. Certainly, each creditor situation is different depending on whether the obligation is secured with all or a portion of the debtor’s assets or whether the debt is purely unsecured. Nonetheless, developing a pre- and post-petition strategy for dealing with a financially troubled entity will enhance a creditor’s chances for recovery. The following are some of the considerations creditors may want to ponder:

- ▶ **Whether to extend credit pre-petition.** Most cash-depleted debtors have extended payments of their trade debt to the farthest extreme, and this is a sure sign of an impending bankruptcy. Although a supplier or vendor may have a long-standing relationship with the debtor and/or may want to continue doing business with the debtor, a prudent collection officer will watch terms and payments carefully. If the company does file, the debtor will be prevented from paying pre-petition debt.
- ▶ **Whether to extend credit post-petition.** After the filing, a vendor supplying goods and services to the debtor on an open account is not required to continue doing business with the debtor, nor is it required to extend credit terms. Although post-petition obligations incurred by the debtor have administrative priority status and are supposed to be paid as they become due, payment really hinges on the viability of the debtor’s business. Some debtors will ask the Bankruptcy Court to allow the payment of pre-petition debt to so-called “critical vendors.” This request is usually coupled with the creditors’ agreement to extend post-petition credit terms.

- ▶ **Serving on the Unsecured Creditors' Committee.** The largest unsecured creditors in a Chapter 11 case are solicited to serve on a committee. The benefit to serving is that it allows a creditor to monitor the case closely. Typically, the Committee's professionals, including attorneys and accountants, are paid by the debtor. Thus, the creditor can participate without having to pay fees and costs on an individual basis.
- ▶ **Filing a Proof of Claim.** A critical time to note is the deadline for filing a proof of claim. It varies depending under what Chapter the case has been filed.
- ▶ **Objecting to the Discharge.** In an individual's bankruptcy case, a creditor may want to object to the dischargeability of the creditor's particular debt or to the individual's discharge as a whole. There are strict deadlines for filing these objections.
- ▶ **Filing a Motion to Lift Stay.** Depending on the nature of the debt, a creditor may want to seek approval from the Bankruptcy Court to allow it to continue with a foreclosure action, a pending lawsuit, or some other state or federal law remedy.
- ▶ **Filing a Motion to Appoint a Trustee or an Examiner.** In situations where management of a company in Chapter 11 is guilty of misconduct or gross mismanagement, or even in situations where members of a board of directors are at odds with one another, a creditor may want to ask the Bankruptcy Court to appoint a trustee to take control of the debtor. Or, at a minimum, a creditor which has suspicions that assets may have been dissipated or unaccounted for may seek the appointment of an examiner who has the court-appointed responsibility to review the debtor's books and records and report on the status.

- ▶ **Filing a Creditor Plan.** Once the debtor's exclusivity has terminated, any creditor is free to file a plan. This may be the creditor's opportunity to force a liquidation of the debtor's assets or a change of management.
- ▶ **Compelling Assumption or Rejection of Contracts or Leases.** A creditor, who is a party to a contract or lease with the debtor, may want to request the Bankruptcy Court to force the debtor to assume or reject the contract or lease early in the case as a means of obtaining payments.

The amount of a creditor's debt will certainly dictate the amount of effort to be spent in pursuing various remedies and alternatives. However, in every case, detecting and addressing early on the problems with a distressed company is the key to a successful outcome.

Bankruptcy from an Outsider's Standpoint — the Investor or Purchaser

“Television is NOT real life. In real life people actually have to leave the coffee shop and go to jobs.”

— BILL GATES

Some participants in the bankruptcy process have no connection with debt obligations. Rather, they are outside parties who want to purchase assets from, invest capital in, or merge with a company in a bankruptcy proceeding. Clearly, implementing these types of transactions through the Bankruptcy Court can have significant benefits.

For example, the bankruptcy §363 sale mechanism allows a sale of the debtor's assets to occur “free and clear of liens and interests.” The liens and interests attach to the proceeds, which the debtor disburses appropriately. That may permit a purchaser to acquire the assets without having to delve into disputes with creditors, and with little or no risk of successor liability, bulk sale claims or the like. The sale can be conducted expeditiously depending on the circumstances of the case. And, bankruptcy orders confirming sales are seldom overturned.

Similarly, investments of capital, post-bankruptcy extensions of credit, and mergers can be accomplished free of many of the risks attendant with these transactions outside of bankruptcy. Because the bankruptcy process involves extensive noticing procedures and disclosure, some federal and state restrictions applicable outside of bankruptcy may not be imposed in bankruptcy. It is important to know how these transactions work before an offer is made so as to maximize the protections and benefits of the bankruptcy process.

Conclusion

“If you're riding ahead of the herd, take a look back every now and then to make sure it's still there.”

— WILL ROGERS

Jennings, Strouss & Salmon Business Restructuring and Reorganization Section

Jennings Strouss attorneys pride themselves on creativity, coupled with a pragmatic approach to the resolution of bankruptcy and creditor/debtor issues.

Jennings Strouss' expertise encompasses a full range of representation in every aspect of commercial restructuring and reorganization. The core section of lawyers brings together years of experience in debtor/creditor matters. Coupled with the depth of the Firm's corporate, securities, real estate, tax, labor/employment, health care, intellectual property and litigation practices, Jennings Strouss has the ability to service the needs of any client in any type of financially-distressed situation from either the debtor or creditor perspective.

Complex Debtor Reorganizations

Jennings Strouss lawyers have represented public and private companies, partnerships and individual Chapter 11 debtors in significant cases involving sizeable real estate holdings, regional and national retail chains, health care concerns, manufacturing businesses, and airlines.

Creditors' Committees

The Firm has extensive experience in representing Chapter 11 creditors' committees, including representation in virtually every major case filed recently in the District of Arizona.

Purchases and Sales

We have structured numerous acquisitions in bankruptcy cases as well as represented a multitude of clients purchasing assets or stock from bankruptcy estates.

Landlords and Bankruptcy

Our lawyers have extensive experience in representing landlords affected in cases ranging from simple single-asset cases to those involving multiple retail locations.

General Restructuring

Jennings Strouss regularly advises borrowers and lenders in debt workouts and with respect to business and legal solutions for restructuring financially troubled entities.

Institutional and General Creditors

As part of its broad business practice, the Firm has represented numerous financial institutions and other creditor entities and individuals on all types of debtor/creditor and bankruptcy-related issues ranging from foreclosures, collections and garnishments to lift stay and reorganization matters.

Fraudulent Transfer and Preference Litigation

We have successfully defended business clients sued to recover supposed fraudulent transfers and preferential payments in courts throughout the country.

Complex Insolvency-Related Litigation

Jennings Strouss lawyers have established themselves on the cutting edge of litigating complex insolvency-related theories brought against third-party advisors and officers and directors.

Utilities

The Firm's lawyers have extensive experience in representing utilities in large utility and other debtor cases.

We Are Available to Assist You

The lawyers in the Jennings Strouss Business Restructuring and Reorganization Section are well qualified to assist in virtually any bankruptcy or business restructuring and reorganization matter. If you have a legal matter with which you need assistance, or if you would like more information about our services, please contact any of the following lawyers.

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This booklet is intended for general information purposes only and not as specific legal advice. You are urged to consult an attorney concerning your situation and any specific legal questions you may have. For further information about these contents, please contact the author, Carolyn J. Johnsen, at 602.262.5906 or cjohnsen@jsslaw.com.

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