Foreign and Multinational Business Insolvency in the United States

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INTRODUCTION AND OVERVIEW

The United States has a relatively efficient and flexible legal structure to deal with insolvent entities. Creditors can be protected by liens upon specific collateral and blanket liens upon essentially all assets of a debtor. Debtors and unsecured creditors can utilize the reorganization provisions of Chapter 11 of the United States Bankruptcy Code to reorganize businesses which require restructuring. These protections are available to foreign entities that do business in the United States and apply to multinational insolvencies. The basic structure of these rights and protections are described in these materials

Secured Claims and Enforcement

Many commercial lenders in the United States require that borrowers secure repayment of their business loans with collateral. The types of collateral sought by commercial lenders will depend on the credit-worthiness of the borrower, the nature of the borrower=s business, the relationship between the collateral and purposes of the loan, the relative value of the borrower=s assets available to be mortgaged as collateral and the feasibility of obtaining prior perfected liens.

For instance, a business loan to a manufacturer is typically secured by the borrower-manufacturer=s inventory of raw material, work in process and finished goods. In addition, the borrower-manufacturer will be expected to further secure the loan with any accounts receivable or proceeds created on the sale of the finished goods. Likewise, a loan obtained for the purpose of purchasing a particular asset or group of assets is typically secured by the asset (or assets) purchased. If the borrower intends to lease the asset to others during the term of the loan, rentals received by the borrower may also be included in the collateral pool.

If the borrower fails to satisfactorily perform its obligation, the lender may exercise a number of remedies. The lender may choose to sue the borrower for repayment and obtain a court-supervised foreclosure sale of the collateral. The lender may also have the option to sell the collateral through non-judicial means. Foreclosure is generally governed by state law, rather than federal law. All states permit non-judicial sales of personal property collateral. However, only a minority of states permit the lender to undertake a non-judicial foreclosure of real estate. Most states require some court supervision of the real property foreclosure.

Unsecured Claims and Enforcement

There are few effective non-judicial methods of forcing an unwilling debtor to pay an unsecured claim. Generally, the creditor is limited to negotiating with the debtor, threatening to report the non-payment to credit reporting agencies and/or withholding future goods and services. The creditor may also use the threat of litigation, and its resulting disruptions and expense, as leverage to force the debtor to pay the unsecured claim.

Should the creditor be unable to persuade the debtor to pay an unsecured claim, the creditor=s next option is usually to commence a lawsuit. The fees for filing a lawsuit and serving the suit papers on the debtor are quite low, usually between $100.00 and $500.00. However, the real expense of a collection lawsuit is the attorneys= fees. In even the simplest of lawsuits, attorneys= fees will usually be a few thousand dollars. For complex litigation involving large amounts of money, this figure can reach hundreds of thousands or even millions of dollars. A small case could be resolved in as few as four to six months. However, it is not unusual to have cases pending for one or more years before they go to trial.

Liquidation

Most small businesses that become insolvent simply cease operations without any formal legal proceedings. The secured creditors liquidate their collateral, which usually consists of all or substantially all of the business= property, plant and equipment. As there are no remaining assets with which to satisfy unsecured claims, there is no need of a formal insolvency proceeding.

When a larger business becomes insolvent, its liquidation is usually conducted through a Chapter 7 bankruptcy proceeding commenced by the business itself. Bankruptcy proceedings are governed by federal law. The Bankruptcy Reform Act of 1978, known as the Bankruptcy Code (11 U.S.C. '' 101 , et seq.) contains the governing statutes of liquidation proceedings. The provisions of the Bankruptcy Code are supplemented by the Federal Rules of Bankruptcy Procedure (Bankruptcy Rules), which address the procedural aspects of bankruptcy practice. The Federal Rules of Evidence for United States Courts and Magistrates are also applicable in bankruptcy cases.

A liquidation under the Bankruptcy Code is conducted by a trustee pursuant to section 704 of the Bankruptcy Code. A trustee is appointed upon the filing of the bankruptcy petition, and although the creditors may elect another trustee at the initial creditors= meeting, this is rare. The creditors may also form a committee to consult with the trustee in connection with the administration of the debtor=s estate, make recommendations to the trustee regarding the performance of the trustee=s duties and submit to the bankruptcy court or the trustee any question affecting the administration of the debtor=s estate. Creditors= committees are rarely formed in Chapter 7 liquidation cases. Businesses may also be liquidated through other state and federal proceedings such as receiverships.

Reorganization

Although many debtors resolve their difficulties by private agreement with their larger creditors, the most common venue for the reorganization of insolvent businesses in the United States is the bankruptcy court. While there are other avenues available, such as equity receiverships, they are not commonly used. Certain heavily-regulated industries have specialized reorganization proceedings. For example, banks are reorganized by the Federal Insurance Deposit Corporation (FDIC), and insurance companies must reorganize through state-regulated insurance rehabilitation proceedings.

Most bankruptcy reorganizations are commenced by the debtor, although the creditors may file an involuntary case against a debtor if they meet certain criteria. In most Chapter 11 (reorganization) cases under the Bankruptcy Code, the debtor remains in control and possession of its assets as a debtor-in-possession. In some instances, for example, where the debtor engages in some form of misconduct, a trustee may be appointed to take possession of the debtor=s assets and operate the debtor=s business. The trustee acts as a fiduciary for the creditors of the debtor=s estate.

MULTINATIONAL INSOLVENCIES

Recognition of Foreign Cases, Representatives

Section 304 of the Bankruptcy Code enables a foreign representative to commence a limited action in the United States, as opposed to a full bankruptcy proceeding, to administer assets located in this country and prevent dilution of assets located here by local creditors. The United States bankruptcy action is actually ancillary to the foreign proceeding.

Pursuant to section 304(c), foreign proceedings must meet the following criteria to qualify for such ancillary judicial assistance.

1. Just treatment of all claimants;

2. Protection of U.S. claim holders against prejudice and inconvenience;

3. Prevention of preferential or fraudulent transfers;

4. Distribution of proceeds of the estate substantially in accordance with the U.S. Bankruptcy Code;

5. Comity; and

6. If possible, in the case of an individual, the provision of the opportunity for a fresh start for the foreign debtor.

If the petition is not challenged on any of the grounds set out in section 304(c), the court may enter an order for relief. Because the ancillary proceeding does not constitute a full bankruptcy proceeding, the section 362 automatic stay does not apply. *However, if the foreign representative anticipates seizure of the foreign debtor=s assets, he may apply for a temporary restraining order under sections 304 or 105 of the Code.*

United States Courts have adopted protocols by judicial order with the courts of other nations conducting parallel foreign proceedings involving the same debtor or group of debtors. Committee J of the International Bar Association has developed a Concordat containing principles relating to such protocols.

Recognition of Foreign Creditors and Claims

In U.S. bankruptcy proceedings, foreign creditors and claim are recognized on equal footing with local creditors, as long as the foreign creditors follow the proper procedures for ensuring their claim is before the court, i.e. filing a proof of claim.

Under common law, a foreign judgment may only be enforced in the United States after an action based on that judgment is instituted in the United States and a judgment obtained on that action. Principles of comity provide that in the absence of a showing of fraud or lack of notice, the underlying issues may not need to be relitigated. Once a U.S. court affirms foreign judgment, the resulting U.S. judgment is enforceable in the same manner as any other domestic judgment.

Return of Assets to a Foreign Representative

A major area of conflict centers around the treatment of U.S. claims against the foreign debtor, because it involves important aspects of public policy. While the principles of comity require that local unsecured creditors not be given preference over, or be subordinated to, claims of other general creditors in a foreign proceeding, the same is not necessarily true for certain types of claims which are considered secured or priority under U.S. law. Generally, the U.S. courts have sided with domestic policy and have not been sympathetic to foreign debtors= attempts to obtain turnover of assets held by U.S. creditors if the secured claim of the creditor is recognized under United States law.

Conflict of Law Issues

Courts have taken a very flexible approach to section 304 of the Bankruptcy Code. This flexibility has led to some conflict of law issues. Generally, the U.S. will look to the principles of comity and international standards in determining the substantive law to apply to particular situations; however, the facts of each case play a major role. See Previous Section above.

CLAIMS AND ENFORCEMENT PREBANKRUPTCY

Security in Real Property

The creation, perfection and enforcement of security interests in real property is governed by the law of the state in which the real property is located. In general, one of two collateral instruments are used: either a mortgage or a deed of trust. A deed of trust is a three-party instrument by which the borrower conveys the borrower=s interest in real property to a trustee for the benefit of the lender during the time the loan is outstanding and unpaid. A mortgage is very similar to a deed of trust, except that a mortgage is a two-party instrument by which the borrower grants a lien in the real property directly to the lender.

Both a mortgage and a deed of trust constitute transfers of interests in real property. All transfers of real property are governed by the law of the state in which the real property is located and each state has its own peculiar requirements regarding permissible terms and manner of execution. If these requirements are fully satisfied, the mortgage or deed of trust is enforceable against the borrower in accordance with its terms and state law. However, before the mortgage or deed of trust is enforceable against third parties (subsequent purchasers of the property and creditors), each state will require that the instrument be recorded in the appropriate governmental records maintained for that purpose. Thereafter, third parties taking an interest in the property do so subject to the lender=s rights under the recorded instrument.

The enforcement of rights granted in a mortgage or deed of trust is also governed by the law of the state in which the property is located. Some states entitle a lender to immediate possession of the property on default, while others require that the lender petition a court for possession. In addition, some states (particularly those recognizing the use of a deed of trust) will permit the lender or trustee to conduct a sale of the property without court supervision, while a majority of other states permit only judicially supervised foreclosures of the property. No matter which method is utilized, state law will govern the manner and method of the sale and the lender must take great care to observe all applicable requirements.

Security Interests in Personal Property

In the United States, most commercial transactions are governed by the Uniform Commercial Code

(AUCC@), a model code that has been enacted (with some variations) by all 50 states. The creation, perfection and enforcement of security interests in personal property are covered by Article 9 of the UCC. However, certain transactions are excluded from Article 9. For example, Article 9 does not govern liens which are regulated by federal law such as security interests in aircrafts and railcars, and ship mortgages. Nor does Article 9 cover interests in real estate (including landlord=s liens).
In general, Article 9 provides that, unless the lender has possession of the collateral, a security interest must be granted pursuant to a written contract or security agreement. When the lender=s security interest Aattaches@ to the collateral, the lender must take the steps prescribed by Article 9 to Aperfect@ its interest and obtain priority over the interests of other creditors or a debtor in bankruptcy. The perfection process is one whose primary purpose is to provide such parties with prior notice of the lender=s interest in the collateral.

The particular steps which must be taken to perfect a security interest will depend on the type of collateral involved. For instance, for certain collateral such as negotiable instruments, the lender may only perfect its security interest by taking physical possession of the collateral. Likewise, for a security interest in accounts of the borrower or contract rights, the lender=s only option to perfect its interest against other creditors is to file a financing statement in the locations prescribed by the applicable state version of the UCC. Other forms of collateral such as goods, negotiable documents and chattel paper may be perfected by either filing or the lender=s physical possession.

For certain types of personal property collateral, the lender must take additional steps to perfect its lien in addition to those provided in Article 9. For instance, to perfect a lien in motor vehicles, some states impose a requirement that the lien be Anoted@ or contain marked notations on the certificate of title evidencing ownership. In addition, certain aspects to obtaining a lien in equity securities (other than those evidenced by a certificate) are governed by requirements contained in Article 8 of the UCC.

Some state and federal laws restrict or regulate the ownership of property by non-U.S. citizens. These restrictions and regulations are, for the most part, directed primarily toward interests in real property and industries involving national defense or national security. The federal law and the law of each applicable state must be examined to ascertain the requirements (if any) that must be satisfied by non-U.S. citizens.

Unsecured Claims

A creditor has few effective non-judicial methods of compelling a debtor to pay an unsecured claim. The creditor must use persuasion and often the concept of reporting the non-payment to credit reporting agencies, withholding future goods and services and commencing litigation.

The threat of litigation can be effective because a lawsuit is often a significant disruption of the debtor=s business and may force the debtor to incur large expenses for attorneys= fees and items such as depositions. While the AAmerican Rule@ is that each party bears its own fees and expenses in a lawsuit, most contracts provide that the prevailing party is entitled to recover its Areasonable@ fees and expenses. Furthermore, many states have adopted statutes authorizing the recovery of attorneys= fees and expenses for a breach of contract claim, such as a suit to recover a debt. Thus, a debtor faces the risk of increased liability if it fails to take advantage of the opportunity to settle the creditor=s claim before the filing of a lawsuit.

The pre-judgment remedies available to creditors vary greatly from state to state. These remedies generally include:

1. A writ of sequestration, which allows the creditor to seize from the debtor property in which the creditor has an interest;

2. A writ of attachment, which allows the creditor to seize any non-exempt property of the debtor;

3. A writ of garnishment, which allows the creditor to seize from third parties any non-exempt property of the debtor;

4. An injunction, which prohibits the debtor from performing specific acts or, occasionally, requires the debtor to perform specific acts; and

5. A receivership, by which the court appoints an individual to take over the management of the debtor=s business and/or assets.

When a lawsuit is filed in federal rather than state court, the federal court may provide those pre-judgment remedies available under the law of the state in which the court is located.

Pre-judgment remedies deprive the debtor of the use and control of its property before its liability on the creditor=s claim is determined by a court. Therefore, the United States Constitution requires a hearing before a judge at which the creditor must establish its right to the relief requested. Almost all pre-judgment remedies also require a bond to compensate the debtor if the relief is improperly granted.

In addition to the hearing and bond requirements, each state has established by statute its own criteria for pre-judgment writs and receivership. Generally, the creditor must show through affidavit testimony that the debtor is engaged in conduct specifically designed to prevent the creditor from being able to recover on a judgment that may be entered in its favor. For example, in Texas, a writ of attachment is available under the following circumstances:

(i) The defendant is not a resident of this state or is a foreign corporation or is acting as such;

(ii) The defendant is about to move from this state permanently and has refused to pay or secure the debt due the plaintiff;

(iii) The defendant is hiding so that ordinary process of law cannot be served on him;

(iv) The defendant has hidden or is about to hide his property for the purpose of defrauding his creditors;

(v) The defendant is about to remove his property from this state without leaving an amount sufficient to pay his debts;

(vi) The defendant is about to remove all or part of his property from the county in which the suit is brought with the intent to defraud his creditors;

(vii) The defendant has disposed of or is about to dispose of all or part of his property with the intent to defraud his creditors;

(viii) The defendant is about to convert all or part of his property into money for the purpose of placing it beyond the reach of his creditors; or

(ix) The defendant owes the plaintiff for property obtained by the defendant under false pretenses.

Tex. Civ. Prac. & Rem. Code ' 61.002.

The showing that a creditor must make in order to obtain an injunction is not established by statute. Rather, an injunction is an equitable remedy that requires the court to balance several factors to determine what is fair under the unique circumstances of each case. These factors generally include some variation of the following:

1. A substantial likelihood of success on the merits;

2. Irreparable harm to the requesting party if the injunction is not granted;

3. The harm to the requesting party if the injunction is not granted outweighs the harm to the opposing party if the injunction is granted; and

4. The injunction will not disserve the public interest.

In a simple collection lawsuit, a creditor can usually obtain a judgment in four to six months. The creditor typically moves for Asummary judgment,@ which is a procedure by which a party to a lawsuit can obtain a judgment without going through a trial. The moving party must establish each element of its claim through affidavit testimony or certified documents. The responding party must then either point out a disputed issue of material fact regarding an element of the moving party=s claim or establish each element of an affirmative defense. If the opposing party does neither, then the court may enter judgment for the moving party. See Fed. R. Civ. P. 56.

In complex cases where summary judgment is unavailable, a lawsuit will most likely be on file for one or two years before it is tried. In large metropolitan areas, longer waits are not uncommon. Furthermore, antitrust and mass tort suits may be on file for as many as ten years before trial.

The most significant expense associated with a lawsuit is attorneys= fees. In a small lawsuit, fees may be only a few thousand dollars. In a large, complex lawsuit, fees can reach hundreds of thousands and even millions of dollars. While the successful creditor can usually obtain a judgment against the debtor for its attorneys= fees, it is often the case that the debtor is unable to satisfy the entire judgment. In such a circumstance, the creditor may recover only a portion of its original claim and none of its attorneys= fees.

Domestic judgments are usually enforced through a writ of execution, which directs a county sheriff or United States marshal to seize the judgment debtor=s assets, sell them at a public auction and deliver the proceeds to the judgment creditor. See Fed. R. Civ. P. 69(a). A post-judgment writ of garnishment is also available to seize a judgment debtor=s assets held by third parties, such as bank and brokerage accounts. Unlike the prejudgment writs, these post-judgment writs do not require a showing that the debtor is concealing or destroying assets, but only that there is an unsatisfied judgment. There is also no requirement of a bond.

In some states, such as Texas, a judgment creditor may obtain a turnover order, which directs the debtor to assemble its non-exempt property that cannot readily be levied on by ordinary legal process and to deliver that property to the sheriff or marshal for execution. See, e.g., Tex. Civ. Prac. & Rem. Code ' 31.002. This collection procedure effectively places the burden of satisfying a judgment on the debtor.

In order to identify and locate a judgment debtor=s assets, the judgment creditor may conduct post-judgment discovery using the same techniques available during the pendency of the lawsuit. See Fed. R. -Civ. P. 69(a). These techniques include interrogatories, requests for production of documents and depositions.

In general, there are no special requirements for foreign creditors who seek judgments from United States courts on either foreign or domestic claims. However, such a suit may raise significant choice of law issues. Furthermore, the foreign creditor may have to deal with the concept of *forum non conveniens*, whereby a court may dismiss a lawsuit if it is more convenient for the parties and the witnesses and in the interest of justice for it to be tried in another state or country. Finally, the foreign creditor must be aware that commencing a lawsuit in the United States will subject it to the jurisdiction of the United States courts and possibly claims that the debtor and third parties may have against the foreign creditor.

LIQUIDATION

Chapter 7 is the liquidation chapter of the Bankruptcy Code, and is available to individuals, corporations and partnerships. In a Chapter 7 bankruptcy case, the debtor ceases to have any legal authority with respect to the property of the bankruptcy estate, the manner of its disposition, or the distribution of the proceeds. Chapter 7 is structured to provide for the appointment of a Chapter 7 trustee to supervise the expeditious conversion of the estate=s assets to cash, and distribute the proceeds of those assets to creditors in accordance with the schedule of distribution contained in the Bankruptcy Code. The liquidation of the estate is conducted according to the Bankruptcy Code and Rules and the Chapter 7 trustee does not have discretion or flexibility with respect to the manner in which the proceeds of a liquidation will be distributed to creditors.

Principal Laws Governing Liquidation

Chapters 1, 3 and 5 of the Bankruptcy Code apply in all bankruptcy cases. Chapter 1 contains definitions and rules of construction, specifies who may be a debtor in different forms of cases, governs waiver of sovereign immunity and includes a provision (section 105) which gives broad authority to the bankruptcy court to enter orders. Chapter 3 covers how a case is commenced, governs officers and their compensation, provides for an automatic stay and borrowing by a debtor and provides the provisions on protection to creditors. Chapter 3 also regulates the use, sale or lease of property, obtaining credit by the debtor in possession or the trustee and the assumption and rejection of executory contracts. Chapter 5 determines what constitutes property of the estate, the rights of creditors, priorities among creditors and contains a provision which authorizes the Bankruptcy Court to determines the tax obligations of debtors. Chapter 5 also contains the avoiding powers of the trustee or debtor in possession which authorize the trustee or debtor in possession to avoid certain transfers, including preferential and fraudulent transfers and unauthorized post petition transfers.

Courts Which Administer Liquidation

Chapter 7 liquidation cases are federal proceedings commenced in the bankruptcy court. Although the Bankruptcy Code as enacted in 1978 vested the bankruptcy court with general jurisdiction over all matters involved in a bankruptcy case, the Supreme Court invalidated this broad grant of jurisdiction in *Northern Pipeline Co. v. Marathon Pipeline Co.*, 458 U.S. 50, 102 S. Ct. 2858 (1982). Although the *Marathon* opinion is complex, it turns in part upon United States constitutional principles that cases and controversies should be heard by so-called Article III judges, i.e., judges who enjoy life tenure and compensation protection. In response to *Marathon*, the United States Congress enacted and passed the Bankruptcy Amendments and Federal Judgeship Act of 1984 (BAFJA).

The jurisdictional provisions regarding Bankruptcy Courts have now been codified in 28 U.S.C. section 1334 and 28 U. S. C. section 157 which vests the initial jurisdiction regarding bankruptcy cases in the United States District Court, but refers most matters to the Bankruptcy Court, which is a unit of the District Court. Most bankruptcy proceedings are conducted by the Bankruptcy Court. Rulings of the Bankruptcy Court may be appealed to the District Court or the Bankruptcy appellate Panel, and then to higher appellate courts.

Venue of bankruptcy cases is governed by 28 U.S.C. ‘’ 1408-10 and 1412. In order to establish venue, the debtor must have been domiciled or had a residence, principal place of business or principal assets in the district for the 180 days immediately preceding the date of the petition, or for a longer part of such 180 days than in any other district. This simply means that venue is proper in a district if the debtor has been in that district more than 91 of the preceding 180 days. Section 1412 provides for change of venue for the convenience of the parties or in the interest of justice. Because many United States corporations are incorporated in the State of Delaware, many Chapter 11 cases have been filed in Delaware.

Commencement of a Liquidation

A case under the Bankruptcy Code is commenced by the filing of a petition with the bankruptcy court. The petition may be filed by the debtor (a Avoluntary@ petition) or by the petitioning creditors against the debtor (an Ainvoluntary@ petition). A voluntary petition under Chapter 7 may be filed by any debtor who meets the eligibility standards of section 109 of the Bankruptcy Code which authorizes the filing of a Chapter 7 case by most entities.

Section 109 excludes certain persons from eligibility under Chapter 7 including railroads, domestic insurance companies, banks, savings banks, cooperative banks, savings and loan associations, building and loan associations, homestead associations and credit unions as well as foreign insurance companies, banks, savings banks, cooperative banks, savings and loan associations, building and loan associations, homestead associations, or credit unions engaged in such business in the United States. Legislative history indicates that such entities are excluded under section 109 since they are subject to regulations by other supervisory authorities.

If the debtor is a corporation, the petition must contain a declaration of the president, other officer of the corporation or authorized agent verifying that the filing of the petition on behalf of the debtor has been authorized. A voluntary petition filed on behalf of a partnership may be filed by one or more of the general partners, if all general partners consent to the petition.

Under certain limited conditions, creditors may commence involuntary proceedings under the Bankruptcy Code to force a debtor to liquidate its nonexempt assets. An involuntary case may be commenced against any entity eligible for relief under Chapter 7 except farmers and non-profit corporations. An involuntary case against a partnership may be filed by less than all of the general partners since a voluntary petition requires that all general partners consent. Finally, an involuntary petition may be filed against a partnership when relief has been ordered for all of the general partners.

Section 303(b) of the Code outlines the eligibility requirements to participate as a petitioning creditor in an involuntary proceeding. Section 303(b) provides that an involuntary case may be commenced by three or more entities, each of which is either a holder of a claim that is not contingent as to liability or the subject of a bona fide dispute against the debtor. Such claims, however, must aggregate at least $10,775 more than the value of any lien on property of the debtor securing such claims. Thus, partial secured creditors may be involuntary petitioners. If there are fewer than twelve creditors against the debtor (excluding employees, insiders and transferees with respect to certain voidable transfers) then only one petitioning claimant is necessary so long as it holds unsecured claims aggregating at least $10,775. The other procedural requisite for filing an involuntary petition is that it must meet the standards of Section 303(h) of the Code, which provides that if the petition is not timely converted to a voluntary petition, the court shall order relief against the debtor only if

1. The debtor is generally not paying its debts as they become due, unless such debts are the subject of a bona fide dispute; or

2. Within 120 days before the date of the filing of the petition, a custodian was appointed or took possession of the debtor.

The filing of a bankruptcy petition, whether voluntary or involuntary, invokes an automatic stay pursuant to section 362 of the Code, preventing essentially all actions against the debtor or property of the estate. The concept behind the automatic stay is the right of the debtor to have a Abreathing spell@ - an opportunity to rehabilitate and formulate a plan of reorganization or liquidate in an orderly fashion. Section 362(a) enumerates the actions which are subject to the automatic stay. The language is very broad and all inclusive and applies to all entities as defined in section 101(15) of the Bankruptcy Code. Among other things, the automatic stay applies to the commencement or continuation of legal or administrative proceedings, the enforcement of judgments, the creation, perfection and enforcement of liens, set off of claims and any act to exercise control over property of the estate. The stay in commercial insolvencies normally does not extend to third parties, such as guarantors, but has been interpreted to apply to situations where actions against third parties would necessarily result in liability to the debtor. In addition, section 105 of the Bankruptcy Code has been used to enjoin actions against third parties when such action would be detrimental to a reorganization effort. Several actions are excluded from the scope of the automatic stay including criminal proceedings, the collection of alimony, maintenance or support, certain post petition lien perfection action, the enforcement of police or regulatory powers, and certain commodities setoffs, margin transactions and repurchase arrangements. Before taking any actions against a debtor, a creditor should closely review the provisions of section 362 to avoid any violations of the automatic stay. Section 362 contains provisions for relief from the automatic stay for certain specified reasons and for cause.

Parties to a Bankruptcy Case

Debtor--The debtor is the person or entity who seeks voluntary relief under the Bankruptcy Code, or who has been forced involuntarily into bankruptcy by petitioning creditors.

Debtor-in-Possession--In a Chapter 11 bankruptcy case, the debtor becomes a debtor in possession (unless or until a trustee is appointed) which operates its own business, and remains in possession of its assets and property pursuant to section 1101. The Chapter 11 debtor in possession has the rights, powers and duties of a trustee and must manage the estate=s assets in accordance with the requirements of the Bankruptcy Code.

Bankruptcy Judge--The bankruptcy judge presides over the administration of a bankruptcy case and decides contested aspects of that case. A bankruptcy judge does not become actively involved in the daily administration of the bankruptcy case, as that task has been delegated to the debtor, the United States Trustee and any appointed trustee.

Bankruptcy Court Clerk--The clerk of the bankruptcy court receives all documents which are placed in the court record in a bankruptcy case. In addition, the clerk=s office schedules hearings to be heard by the bankruptcy judge, usually upon written request by an attorney.

United States Trustee--In almost every jurisdiction, a United States Trustee has been appointed by the United States Attorney General to supervise all bankruptcy cases filed in that particular district. In Chapter 7 cases the United States Trustee is responsible for appointing individual trustees. The United States Trustee is responsible for appointing trustees when a trustee is ordered appointed by the bankruptcy judge in a Chapter 11 case.

Trustee--Trustees represent the creditors= interests in a bankruptcy case. A trustee may be any individual who, by experience or training, is qualified to liquidate property of the debtor, or who can operate the debtor=s business. The United States Trustee in each district maintains a list of such qualified individuals who may be appointed to serve as the trustee in a particular bankruptcy case. The role of a Chapter 7 trustee is to collect all of the assets of a debtor, liquidate the assets for the benefit of the debtor=s creditors, and make a distribution to the debtor=s creditors. In addition, the Chapter 7 trustee may investigate a debtor=s affairs to determine what assets, if any, the debtor possesses. Sections 701 through 704 of the Bankruptcy Code govern the Chapter 7 trustee=s duties. Generally, a trustee is not appointed in a Chapter 11 bankruptcy case unless the debtor-in-possession engages in some type of misconduct. If a trustee is appointed by the court in the Chapter 11 case, the trustee will take possession of the debtor=s estate, and operate the debtor=s business. In addition, a Chapter 11 trustee may file a schedule of assets and liabilities of a debtor, investigate any of the debtor=s actions, and file a plan of reorganization.

Creditors--The principal intended beneficiaries of a bankruptcy case are the creditors, who have a specific right to be heard in bankruptcy cases. Section 101(10) of the Bankruptcy Code defines a Acreditor@ as an entity that has a claim against the debtor which arose prior to the commencement of a bankruptcy case. The interests of unsecured creditors in Chapter 7 cases are usually protected by the appointed Chapter 7 trustee. Secured creditors also often play major roles in Chapter 7 cases. The interests of unsecured creditors in Chapter 11 cases are usually protected by the creditors= committee and, if appointed, the Chapter 11 trustee. The debtor in possession also owes a fiduciary duty to the creditors. Secured creditors also often play major roles in Chapter 11 cases.

Professionals--Upon order of the bankruptcy court, the various parties in interest may retain attorneys, accountants, appraisers, real estate brokers, auctioneers or other professionals to perform specialized functions within a bankruptcy case. Individual creditors or parties in interest do not have to obtain court approval for the retention of such professionals. The decision to retain such professionals depends upon numerous factors, including the complexity of the case and the amount and type of assets involved in the bankruptcy case. The compensation of such professionals is strictly scrutinized by the United States Trustee and the bankruptcy court.

Examiner--Only the bankruptcy court may appoint an examiner in a Chapter 11 case. Unlike the appointment of a trustee, the appointment of an examiner does not change the status of a debtor as debtor in possession. The duties of an examiner are limited to conducting an investigation of the acts and business affairs of a debtor in possession, but may be expanded by order of the court.

Creditors= Committee--In Chapter 11 bankruptcy cases, committees are appointed by the United States Trustee. Generally, an unsecured creditors= committee represents the interests of all unsecured creditors. If there are no unsecured creditors in a bankruptcy case, or if fewer than three unsecured creditors are willing to serve on a committee, an unsecured creditors= committee might not be appointed unless specifically requested. Additional committees may be appointed at the discretion of the bankruptcy court to represent equity security holders or other significant interests in a bankruptcy case in order to assure adequate representation of that creditor group within the bankruptcy case.

The Liquidation Estate

Although all of the debtor=s assets are part of the bankruptcy estate, section 522 of the Bankruptcy Code allows an individual (as opposed to a corporation or a partnership) debtor to exempt certain property from his or her bankruptcy estate. The debtor=s exemption claim removes these assets from the bankruptcy estate, and allows the debtor to retain them free from the claims of his or her unsecured creditors.

The Bankruptcy Code provides for a set of standard federal exemptions that a debtor may elect to claim unless the debtor=s state provides that the federal exemptions may not be claimed. Although most states have Aopted out@ of the federal exemptions, some states allow a debtor to elect either the federal exemptions found in the Bankruptcy Code or the state exemptions for the particular state of the debtor.

Section 722 of the Bankruptcy Code provides that an individual debtor may redeem personal property intended primarily for personal, family or household use from a lien securing a dischargeable consumer debt, if the property is exempted under Section 522 of the Bankruptcy Code or has been abandoned under Section 554, by paying the lienholder the amount of their allowed secured claim. The right to redeem amounts to a right of first refusal for the debtor to purchase consumer goods that might otherwise be repossessed.

If an individual debtor cannot redeem property, the creditor may permit the debtor to reaffirm the debt secured by the property under section 524(c) of the Code. Reaffirmation agreements generally contemplate reaffirmation of the entire debt and accrued interest. Such agreements must be reviewed by the bankruptcy court at a hearing at which the debtor or his attorney must assure the court that reaffirmation is both in the debtor=s best interest, and that the agreement will not work a hardship. These agreements may be rescinded Aat any time prior to discharge or within sixty (60) days after such agreement is filed with the court, whichever occurs later, by giving notice of rescission to the holder of ... [the] claim.@ 11 U.S.C. ‘ 524(c)(4).

The Chapter 7 trustee is charged with the responsibility of liquidating all property of the estate and distributing the proceeds of those assets to creditors in accordance with the schedule of distribution contained in the Bankruptcy Code.

A trustee may sell its property free and clear of all liens, claims and interests pursuant to section 363 if certain conditions are met, including if the sale exceeds the price of all liens secured by the property, if the third party could be required to accept a money satisfaction for its interest or if the interest of third parties in the property is in dispute. Property may be sold free of the interests of co-owners if partition in kind is impracticable, the sale of an undivided interest will not maximize value, the benefit to the estate outweighs the detriment to the co-owner and the property is not used in the production of certain kinds of energy.

Underscoring this objective of maximum liquidation value is the notion of practicality. Not every asset in the debtor=s estate must be held by the trustee for ultimate liquidation on the open market. The trustee is responsible for concentrating his or her efforts on preserving and liquidating only those assets which will maximize the benefit to the debtor=s estate, which in turn will satisfy creditors. In this respect, abandonment aides the trustee in achieving the goal of maximizing creditor recoveries.

Abandonment is a means by which the trustee relinquishes the estate=s interest in property of the estate. Certain property of the estate is abandoned when in the opinion of the Trustee retention and subsequent liquidation of the assets would result in a superfluous or negligible gain or possibly even a net loss to the estate. The trustee may abandon any property of the estate after notice and opportunity for a hearing pursuant to ‘ 554(c) of the Bankruptcy Code.

Rule 9019 of the Bankruptcy Rules authorizes the trustee to compromise claims and other disputes pursuant to court order. Notice of the proposed compromise must be given to creditors and other parties in interest who are entitled to oppose the compromise.

Trustee=s Avoidance Powers

The Bankruptcy Code empowers a trustee (or Chapter 11 debtor-in-possession) to recover or avoid certain transfers made or obligations incurred by a debtor within specified time periods prior to the filing of the bankruptcy petition. The abilities granted trustees are generally referred to as Aavoidance powers@ and are governed by sections 544 through 550 of the Bankruptcy Code. The most commonly used avoiding powers are those contained in section 547 (preferential transfers) and section 548 (fraudulent conveyances). Using these avoidance powers, the trustee can retroactively analyze the pre-bankruptcy activity of the debtor; if the debtor made transfers, incurred obligations or otherwise took actions inconsistent with the principal of equality of distribution, then the trustee may be able to unwind the transfer or obtain compensation from the person who received the transfer or benefited from it.

Certain time limitations apply to the trustee=s avoidance actions. With respect to preferences, there is a 90 day period prior to filing the petition during which certain payments to creditors may be avoided as preferential (i.e., as violating the equality of distribution rule). There is also a one year insider preference period which permits the avoidance of transfers to persons defined as Ainsiders@ pursuant to section 101 (31) of the Bankruptcy Code. With respect to fraudulent conveyances, the trustee=s section 548 and section 544 (b) rights extend to those transfers which occurred within up to six years before the filing of the bankruptcy petition.

Section 547(b) sets out the elements which must be established by the trustee in order to prove a preference and thus avoid the transfer. For a transfer to be avoided, it must meet all of the following criteria:

1. There must be a transfer;
2. Of the debtor=s property or an interest in the debtor=s property;
3. Which is to or for the benefit of a creditor;
4. The transfer must be an account of an antecedent debt;
5. And made at a time when the debtor is insolvent;
6. The transfer must have occurred within 90 days (or one year if the creditor is an insider) before the filing of the bankruptcy petition; and
7. The transfer must result in the creditor receiving more payment than that creditor would receive:

- Under Chapter 7 liquidation of the debtor=s assets;
- If such payment had not been made; and
- If the creditor received payment as other similarly situated creditors in the bankruptcy case.

There are several statutory defenses to an allegation that a creditor received an avoidable preferential transfer such as transfers in the ordinary course of the debtor=s business and contemporaneous exchanges for new value.

There are two general categories of transfers which may be attacked as fraudulent under the Bankruptcy Code and thus avoidable if made within one year of the filing of the bankruptcy petition. Provision is made for avoidance of transfers:

1. Undertaken with actual intent to defraud (section 548(a)(1) of the Bankruptcy Code); and

2. Where the debtor receives less than reasonably equivalent value as consideration of the transfer at a time when the debtor is insolvent, has unreasonably small capital or believes it will be unable to pay its debt as those debts become due (section 548(a)(2)).

Certain state fraudulent transfer laws may also apply which may permit recovery of fraudulent transfers older than one year.

Creditors and Claims

Shortly after a bankruptcy case is filed, all creditors who were scheduled by the debtor receive notice of the commencement of the case, the date and time of the first meeting of creditors and the fixing of certain dates and deadlines in the case. One of the most important deadlines in a bankruptcy case is the bar date for filing proofs of claim. In Chapter 7 cases, the claims bar date is 90 days after the initial date scheduled for the first meeting of creditors (which meeting typically is held approximately 30 days after the petition is filed). In Chapter 11 cases the time for filing claims is determined by the court. Section 101(5) of the Bankruptcy Code defines >claim= and includes contingent, disputed and unliquidated obligations.

A proof of claim should be prepared in the form of a written statement setting forth the creditor=s claim and attaching any writings or documentation upon which the claim is based. The claim is then filed with the bankruptcy court. The trustee has the duty to examine all proofs of claim and object to any improper claims.

PRIORITIES

Priority in Specific Collateral

Secured and general unsecured claims against the debtor may be filed. In addition to secured claims, certain claims are entitled to priority pursuant to section 507 of the Bankruptcy Code. These priority claims include, but are not limited to, expenses incurred in the administration of the bankruptcy estate, claims for wages or salaries (up to $4,300 and incurred within 90 days of the petition date), limited employee benefits and certain types of unsecured tax claims. Claims for the breach of leases of real property are limited and certain claims are subordinated to other claims. Foreign creditors are entitled to participate in the distribution equally with local creditors, as long as they have followed the appropriate steps for asserting their claims. Often creditors misunderstand where they rank in the priority scheme since only part of the priority system is set forth in the Apriority@ section of the Bankruptcy Code. The actual priorities are as follows:

Surcharging Secured Creditor Collateral

The highest priority available with respect to specific collateral is the ability to charge a secured creditor=s collateral with the costs and expenses of preserving or disposing of the property under section 506(c) of the Code. Courts have been reluctant, however, to permit trustees or debtors-in-possession to Asurcharge@ a secured party=s collateral for payment of administrative expenses unless the expenditure was primarily for the benefit of the secured creditor.

Priming Liens

The next highest priority with respect to specific collateral is a priming lien which is granted for new money provided by section 364(d) of the Code. These priming liens are available to the debtor to permit borrowing in circumstances in which it can be virtually certain that the priming lien will not impair the recovery which the primed lienholder would enjoy in the absence of a priming lien. Section 364(d) of the Code permits the court to give an entity a lien on already encumbered property of the estate, senior or equal to all other existing liens.

Pre-Petition Security Interests

The next priority are the normal prebankruptcy secured claims pursuant to section 506(a) of the Code. Normal pre-bankruptcy properly perfected secured claims are to be paid, at a minimum, to the full extent of the value of the creditor=s collateral. *See* 11 U.S.C. ‘ 506. Further, certain set-off rights are also treated as secured claims by section 506(a) of the Code.

Junior Secured Creditors

Beneath senior lienholders are prepetition subordinate or junior liens pursuant to section 506(a) of the Code. Such subordinate liens may also consist of court-ordered subordinate liens for new money loaned to the debtor after the commencement of the case. *See* 11 U.S.C. ‘ 364(c)(2).

Priority Among Unsecured Claims

Unsecured Super-Super Priority Creditors

The highest priority among unsecured claims are court-ordered unsecured priority claims for new money made available to the debtor pursuant to section 364(c)(1) of the Code. Such Asuper-super priority@ claims are authorized by the court to a creditor who extends postpetition credit to the debtor. Such a Asuper-super priority@ claim has priority over all administrative expenses set forth in sections 503(b) or 507(b) of the Code.

Inadequate AAdequate Protection@Super Priority Creditors

Section 507(b) of the Code grants the inadequately protected secured creditor a priority superior to the administrative and other priority claims in the case (the so-called Asuper-priority@ claim).

Administrative Expense Priority

Claims entitled to priority under section 507(a) are next in line. Section 507(a) ranks the various claims entitled to priority under that subsection. The highest ranking claims under section 507(a) are administrative expenses allowed under section 503(b), and any fees and charges assessed against the estate under Chapter 123 of Title 28. *See* 11 U.S.C. ‘ 507(a)(1). Section 503(b) covers costs and expenses of preserving the estate. Such costs and expenses include post petition rents, employee costs, certain postpetition taxes, fines and penalties, and compensation to certain creditors. Such costs also include the cost of professionals necessary to navigate the case through the bankruptcy process including trustees, examiners, indenture trustees, attorneys and accountants and other costs incurred by the estate after the filing of the petition.

Section 726(b) provides that if a case is converted from Chapter 11 to a Chapter 7 case, the costs of administration incurred in connection with the Chapter 7 case have priority over the costs of administration incurred in connection with the preceding Chapter 11 case.

Involuntary Case AGap@ Claims

Unsecured claims arising in the ordinary course of business or financial affairs of the debtor between the time an involuntary petition is filed against a debtor and the earlier of the appointment of a trustee or the entry of an order for relief. 11 U.S.C. ‘ 507(a)(2). The priority afforded these involuntary Agap@ claims protects those creditors who deal with the debtor during this gap period because such creditors typically may not have any knowledge of the filing of the involuntary petition.

Wage and Salary Claims

Allowed unsecured claims for wages, salaries or commissions, including vacation, severance and sick leave pay earned by an individual within 90 days before the date of the filing of the petition or the date of the termination of the debtor=s business, whichever occurs first. These types of priority claims are limited to $4,300 for each individual. 11 U.S.C. ‘ 507(a)(3).

Contributions to an Employee Benefit Plan

Unsecured claims for contributions to an employee benefit plan arising from services rendered within 180 days before the earlier of the date of the filing of the petition or the date of the cessation of the operation of the debtor=s business. 11 U.S.C. ‘ 507(a)(4). This priority is limited to the number of employees covered by each plan multiplied by $4,300, less the aggregate amount paid by the debtor to such employees for priority wage claims pursuant to section 507(a)(3), plus the aggregate amount paid by the debtor on behalf of such employees to any other employee benefit plan.

Claims Against Grain Storage and Fish Storage/Processing Facilities

The fifth priority under section 507(a) claim status concerns persons engaged in the production or raising of grain, who are doing business with a debtor who owns or operates a grain storage facility and to United States= fishermen who are doing business with a debtor who owns or operates a fish storage or processing facility. 11 U.S.C. ‘ 507(a)(5)(A) & (B). This priority is limited to $4,300.

Deposits by Consumers

Unsecured claims of individuals, to the extent of $1,950 for each such individual, arising from the prepetition deposit of money with the debtor, in connection with the purchase, lease or rental of property, or the purchase of services for the personal, family or household use of the creditor, if the goods or services were not delivered or provided. 11 U.S.C. ‘ 507(a)(6).

Alimony and Child Support

Certain claims of a spouse, former spouse, or child of the debtor. Such claims include alimony, maintenance or support of such spouse or child in connection with a separation agreement, divorce decree or other order of a court. 11 U.S.C. ‘ 507(a)(7).

Priority Tax Claims

Certain unsecured tax claims of governmental units that are not more than three years old. 11 U.S.C. ‘ 507(a)(8). This priority status applies to taxes measured by income or gross receipts, property taxes, taxes required to be collected or withheld for which the debtor is liable in any capacity, employment taxes, excise taxes, customs duties, and certain penalties assessed for non-payment of the aforementioned taxes.

Obligations to Agencies Regulating
Federally Insured Depository Institutions

Allowed unsecured claims based upon any commitment by the debtor to a Federal depository institutions regulatory agency to maintain the capital of an insured depository institution. 11 U.S.C. ‘ 507(a)(9).

Nonpriority Unsecured Claims

If there are any funds left in the estate after all of the claims listed above have been paid in full, holders of allowed unsecured nonpriority claimsC*i.e.*, claims that are not encompassed by any of the Code=s priority provisionsCare next in line for distributions from the estate.

Late-Filed Claims in Chapter 7 Cases

Pursuant to section 726(a)(3), claims, other than claims entitled to priority under section 507, filed by persons with notice or actual knowledge of the claims bar date, that are tardily filed are subordinated to general unsecured claims in a Chapter 7 case. Note that in cases filed under other chapters of the Code, late-filed claims are disallowed entirely. *See* 11 U.S.C. ‘ 502(b)(9).

Penalty Claims in Chapter 7 Cases

In Chapter 7 cases, claims (whether secured or unsecured) for prepetition (or pre-trustee appointment) fines, penalties or forfeitures, or for multiple, exemplary, or punitive damages are subordinated below late-filed claims. 11 U.S.C. ‘ 726(a)(4).

Claims for Interest in Chapter 7 Cases

In Chapter 7 cases, in the event that all of the preceding classes of claims have been paid in full, holders of all unsecured claims shall be entitled to interest which shall accrue at the legal rate from the petition date. 11 U.S.C. ‘ 726(a)(5).

Mechanisms for Reordering Bankruptcy Priorities

Subordination Agreements

Subordination agreementsScommonly taking the form of an agreement whereby one (junior) creditor agrees to forgo repayment of the amount owed to it by the debtor until another (senior) creditor of the debtor is paid in full, whether or not the debtor is in bankruptcySare enforceable in bankruptcy to the same extent that such agreements are enforceable under applicable nonbankruptcy law. 11 U.S.C. ‘ 510(a). A subordination agreement only effects the rights of creditors who are parties to the agreement.

Equitable Subordination

Section 510(c) gives bankruptcy courts authority to equitably subordinate secured and unsecured claims and order that any lien securing a subordinated claim be transferred to the estate. This section codifies the principle, enunciated in the oft-cited case of *Pepper v. Litton*, 308 U.S. 295, 307-09 (1939), that bankruptcy courts, as courts of equity, are empowered Ato sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate,@ and to disallow or subordinate claims where necessary to prevent unfairness.

Substantive Consolidation

Substantive consolidation is an equitable doctrine whereby the assets of, and claims against, two or more entities are merged, creating a common fund of assets and a single body of creditors. In addition, claims between the entities are eliminated upon consolidation. The purpose for substantive consolidation is to preserve the assets of the debtor by avoiding the expense and difficulty of sorting out the separate assets and liabilities of the debtor and its affiliate entities, which may or may not also be bankruptcy debtors. Because the entities to be consolidated invariably have different debt-to-asset ratios, substantive consolidation results in the redistribution of wealth among the creditors of the various entities.

Disallowance of Claims Otherwise Valid Under Nonbankruptcy Law

Code provisions such as section 502(b)(6) & (7), which limit the allowable amount of claims arising from termination of leases of real property and employment contracts respectively, are also methods by which the Code prioritizes the rights of creditors. To the extent that a claim subject to one of these provisions exceeds the limitation set forth in the applicable provision, that portion of the claim is given the lowest possible prioritySit is simply disallowed. Note that the claims partially disallowed under these provisions would presumptively otherwise be valid in their full amount under applicable nonbankruptcy law.

Property of the Estate - Trust Fund Doctrine

Property in which the debtor only holds legal title, and not an equitable interest as of the petition dateSin other words, property held by the debtor solely in the capacity of a trustee for the benefit of othersSis excluded from the bankruptcy estate and is not distributed in satisfaction of creditors= claims. 11 U.S.C. ' 541(d). Technically speaking, property held in trust by the debtor does become property of the estate, but does so Aonly to the extent of the debtor=s legal title to such property.@ *Id*. Rather, property held in trust by the debtor will be distributed solely and directly to the beneficiaries of the trust(s), to the complete exclusion of the claims of creditors of the debtor. In this sense, trust beneficiaries are said to enjoy a priority over creditors to the extent that the amount of trust property in the debtor=s possession as of the petition date is sufficient to satisfy the amount to which the beneficiary is entitled to receive under the trust.

A growing array of state and federal statutes create trust status for specified types of funds transferred pursuant to activities regulated by those statutes, and, in the event of bankruptcy, persons protected by such statutes (such as certain taxing authorities and dealers in perishable agricultural commodities) assume the preferred status of trust beneficiaries rather than creditors.

Discharge of Claims and Debtor

Section 727 governs discharge in Chapter 7 cases. Only an individual person (a human being, not a partnership or corporation) is entitled to receive a discharge in a Chapter 7 case. A Chapter 7 discharge only discharges debts that arose before the filing of the bankruptcy case or, in an involuntary case, before the date on which an order for relief was entered, and operates to prevent creditors with pre-petition claims from pursuing such claims against the individual debtor after the discharge. If the trustee or a creditor can prove that the debtor engaged in certain misconduct, then the debtor will remain personally liable on all of his or her debts. Section 727(a) provides for the denial of a debtor=s bankruptcy discharge if the debtor committed any of the acts specified in that section such as concealing property of the estate or making a false oath or claim in connection with the bankruptcy case.

If the debtor is denied a discharge, then all of his or her debts survive the bankruptcy case, except that any payments received by creditors during the pendency of the case are credited against the surviving debts.

Section 523 provides that certain debts are not discharged. If a creditor establishes that its debt falls within one of the exceptions to dischargeability of a debt, then that creditor has certain rights to seek a court order that its claim not be discharged in bankruptcy.

Section 523(a) excepts from discharge certain taxes and other obligations such as debts for money obtained by fraud and debts for child support.

Officers, Directors and Affiliates

In Chapter 7 proceedings officers, directors and/or affiliates of the Chapter 7 debtor are generally not personally liable for claims against the debtor. This includes such claims as wages or employee benefits owed by the debtor, as well as general unsecured claims. However, personal liability can extend to an officer or director of a Chapter 7 debtor in the event of non-payment of certain types of taxes, for certain environmental claims, for breach of fiduciary duty and for fraudulent or illegal acts committed by the officer or director. The liability of officers and directors under common law may be enforced by a bankruptcy trustee, and such causes of action are normally included as property of the bankruptcy estate.

Officers and directors normally owe a fiduciary duty to creditors, as well as shareholders, when the debtor approaches the zone of insolvency, the time when the directors know, or should know, that the debtor has encountered serious financial difficulty. This duty to maximize the value of the business enterprise is accompanied by a duty of care regarding its assets and operations and a duty of loyalty to the enterprise itself. Affiliates can be liable for controlling the debtor enterprise to the extent that the debtor becomes the mere agent or instrumentality of the affiliate (usually the parent corporation or shareholder) or otherwise misuses the debtor to the detriment of the creditors or to perpetrate a fraud upon the creditors. Officers, directors and affiliates are not automatically liable for trading while the debtor is insolvent unless such parties engage in misrepresentation or other forms of actionable activity.

Claims of officers, directors and affiliates can also be Aequitably subordinated@ to the claims of other creditors. The most frequent basis for equitable subordination is the breach of a fiduciary duty. Normally, this arises when a controlling shareholder, officer or director acts in a way that is unfair to the corporate debtor or preferential to the fiduciary as against the position of other creditors. Evidence of undercapitalization is a significant factor which is considered by the courts.

Shareholders and other affiliates can be held liable for the debts of a corporation. If the debtor is determined to be the Aalter ego@ of the shareholder affiliate. The alter ego doctrine is normally utilized where the stockholders utilize the corporate entity as a sham to perpetuate a fraud, to shun personal liability, or to encompass other truly unique situations. The doctrine is evoked in situations where the legal boundaries of separate entities are ignored by the parties. If multiple entities are operated, in fact, as a single entity, the court may deem them to be alter egos. Commingling of funds is a factor which is often present in alter ego cases. Substantive consolidation is a related doctrine that is used by bankruptcy courts when it is equitable to combine the debtor with a related business entity. Many of the same factors considered in connection with the application of the alter ego doctrine are also considered in connection with a determination of substantive consolidation.

Section 152 of Title 18, United States Code, sets out numerous insolvency related crimes which are punishable by fines and/or imprisonment. These crimes include concealing property of the estate, making false oaths or declarations and presenting false claims against the estate.

Non-Judicial Liquidation

As mentioned previously, the enforcement of liens and security interests in real property is governed by the law of the state in which the real property is located. If the borrower defaults, some states allow the lender to foreclose its security interest through a non-judicial foreclosure sale and thereafter (or concurrently) sue the debtor for a deficiency claim. Be advised, however, that most states require judicially supervised sales of real property. Each state has its own unique and particular notice and other procedural requirements that must be carefully followed before such a sale is valid.
Article 9 of the UCC provides the lender with a number of rights and remedies the lender may exercise in its efforts to enforce the lender=s rights in personal property collateral including the right to

obtain possession of the collateral without court approval or supervision, provided the lender does not Abreach the peace.@ Article 9 also allows the lender to conduct a non-judicial foreclosure sale of the collateral. In conducting such a sale, however, the lender must carefully satisfy the various notice obligations to the debtor, any guarantors, and any other secured creditors claiming an interest in the collateral to be sold. In addition, the lender must conduct the sale in a manner which is Acommercially reasonable.@

REORGANIZATION

Principal Laws Governing Reorganization

Generally speaking, the same laws which govern bankruptcy liquidations apply to business reorganizations. See Page 12 above. Chapter 11 is the principal reorganization chapter of the Bankruptcy Code, and may be used by most entities, including partnerships, corporations and individuals. The purpose of Chapter 11 is to preserve and protect the integrity of assets from the claims of creditors, so as to permit the debtor an opportunity to reorganize and restructure its assets and liabilities and once again become economically viable.

Courts Which Administer Reorganization

As discussed earlier, business reorganizations are normally administered through federal bankruptcy courts, although both state and federal receiverships are occasionally utilized. See pages 13-15 for a detailed discussion of courts and venue.

Commencement of Reorganization

The commencement of a Chapter 11 reorganization proceeding is basically the same as a Chapter 7 liquidation proceeding and may be either voluntary or involuntary. Although there is no statutory requirement that a voluntary Chapter 11 petition be filed in good faith, the bankruptcy courts have held that there is an implicit good faith requirement. In particular, the bankruptcy courts have been more likely to dismiss a Chapter 11 bankruptcy case for lack of good faith where property was transferred to the debtor just prior to the filing in order to obtain the benefits of the automatic stay, or where the sole purpose of the filing was to stay a foreclosure action without any intention of reorganizing through refinancing, sale or other arrangement. Cases filed under Chapters 9, 12 and 13 may only be commenced by the filing of a voluntary petition.

Upon the entry of the order for relief, the debtor=s estate is created as of the original date of the petition. Until entry of the order for relief, however, the debtor remains in control of its assets and may continue to operate its business. After the entry of the order for relief, the debtor may remain in possession of its assets as a debtor in possession.

Reorganization Estate

The filing of a petition for relief under the Bankruptcy Code creates an estate. Section 541 of the Code specifies what becomes property of the debtor=s estate. The concept of property of the estate is broad in scope, encompassing all kinds of property, including tangible and intangible property, causes of action, real and personal property, property held by the debtor in trust for others and property of the debtor held by others.

The creation of a bankruptcy estate has the effect of divesting the debtor of all legal and equitable interests it possessed in property at the time of the bankruptcy filing. In a Chapter 11 case, the debtor becomes the debtor-in-possession, and as such can only transfer estate property in the ordinary course of its business without an order of the court.

Although section 541 specifies the property of the estate, it only contains limited tests for determining what is or is not Aproperty@ for purposes of the debtor=s estate. The courts normally must look to non-bankruptcy law, usually state law, to determine which interests of the debtor are included as property of the estate. Therefore, what becomes property of the estate often varies depending on the applicable state law. As in Chapter 7, a Chapter 11 individual debtor is entitled to exempt certain property from its bankruptcy estate.

The Trustee=s avoidance powers, previously discussed on Pages 18-20, also apply to the Chapter 11 debtor-in-possession or trustee.

Administrative Powers

The Section 362 automatic stay discussed on Pages 14-15 also applies to Chapter 11 reorganization cases. The filing of a bankruptcy petition, whether voluntary or involuntary, invokes an automatic stay pursuant to section 362 of the Code, preventing essentially all actions against the debtor or property of the estate. Section 362 contains provisions for relief from the automatic stay for certain specified reasons and for cause.

The debtor in possession (or trustee, if one is appointed) continues to operate the debtor=s business during the pendency of the case. Section 1107 enumerates the rights, powers and duties of the debtor in possession, while section 1106 sets forth the duties of the trustee and/or examiner. While the debtor may continue to operate its business in the ordinary course, it must obtain court approval for any transactions which are not in the ordinary course of its business. Cash collateral includes cash, negotiable instruments, documents of title, securities, deposit accounts and other cash equivalents as well as the proceeds, products, offspring, rents and profits if both the estate and a third party (usually a secured creditor) has an interest in such items. Section 363 of the Bankruptcy Code provides that the debtor cannot use, sell or lease cash collateral unless the secured creditor consents or the court authorizes such use, sale or lease. If collateral is used, the secured creditor is entitled to adequate protection.

A debtor may sell its property free and clear of all liens, claims and interests pursuant to section 363 if certain conditions are met, including if the sale exceeds the price of all liens secured by the property, if the third party could be required to accept a money satisfaction for its interest or if the interest of third parties in the property is in dispute. Property may be sold free of the interests of co-owners if partition in kind is impracticable, the sale of an undivided interest will not maximize value, the benefit to the estate outweighs the detriment to the co-owner and the property is not used in the production of certain kinds of energy.

For a debtor-in-possession, obtaining financing to support its ongoing operations can be a vital part of the reorganization process. The Bankruptcy Code provides certain incentives and protections for lenders that provide financing to debtors-in-possession. It is important to review these provisions with counsel well in advance of any possible filing. The incurrence of debt, other than in the ordinary course of business, on a secured or unsecured basis requires a court order.

Creditors and Claims

As in a Chapter 7, all Chapter 11 creditors receive notice of the filing of the petition, the date and time for first meeting of creditors, and the deadline for filing proofs of claim. Section 101(5) of the Bankruptcy Code defines Aclaim@ and includes contingent, disputed and unliquidated obligations. The deadline for filing proofs of claim in a Chapter 11 case is fixed by the bankruptcy court. Special rules apply to the filing of claims in Chapter 11 cases. Although any creditor may file a proof of claim in a Chapter 11 bankruptcy only those creditors whose claims have been omitted from the debtor=s schedules, and those creditors whose claims have been scheduled as disputed, contingent or unliquidated must file a claim. Thus, if a creditor is scheduled as undisputed, liquidated and non-contingent, and the creditor agrees with the amount scheduled and the characterization of the claim (secured, unsecured or priority), the creditor need take no further action.

Section 365 of the Bankruptcy Code authorizes the debtor to assume or reject executory contracts and leases. Executory contracts and leases can be assumed by the debtor if the non-debtor party is provided with adequate assurance of future performance and the debtor cures defaults under the executory contract or lease. The debtor may assign the assumed lease or executory contract to a third party if the debtor can establish that the assignee can perform with regard to the lease or contract in the future. Certain contracts cannot be assumed including contracts for financial accommodation and others, for example, personal services contracts and certain intellectual property licences, cannot be assigned.

Section 553 of the Bankruptcy Code preserves the right of setoff but subjects the exercise of the right of setoff to the automatic stay. Section 506 gives to the holder of a right of setoff the rights of a secured creditor, including the right of adequate protection. Certain transfers and manipulations creating rights of setoff are not recognized.

Although the Bankruptcy Code does not exclude environmental claims from the scope of the discharge in Chapter 11, cases have struggled with the distinction between environmental claims that are discharged in the Chapter 11 case and continuing environmental obligations that do not constitute dischargeable claims. Generally, if the environmental obligation arose prepetition and was recognizable at the time of the confirmation it will be discharged unless it relates to property which remains property of the debtor. Injunctive obligations are also often determined to be non dischargeable.

A Chapter 11 debtor receives a discharge when its plan of reorganization is confirmed.

Officers, Directors, Affiliates

The personal liability of corporate officers, directors and affiliates is the same under Chapter 11 as under Chapter 7.

The provisions of section 152 of Title 18, United States Code, regarding insolvency-related crimes (as discussed on Page 28 above) also apply to corporate officers and directors of Chapter 11 debtors.

If the debtor remains in possession, it normally continues to be managed by its officers and directors during the Chapter 11 reorganization, subject to the approval by the Bankruptcy Court of transactions outside of the ordinary course of business. Normally, the management of the debtor devises and prepares the plan of reorganization and presents it to the Bankruptcy Court for approval. This is usually done after intensive negotiations with the representatives of the creditors. Post reorganization management of the debtor is determined by the plan of reorganization, and must be disclosed in the statutory disclosure statement required by section 1125 of the Bankruptcy Code.

Reorganization Plan and Process

The ultimate objective of a Chapter 11 debtor is to obtain court approval of a plan of reorganization which restructures and perhaps, forgives certain pre-petition debt. The relevant sections of the Bankruptcy Code governing the plan itself are sections 1121 through 1129. Section 1121 gives the debtor the exclusive right to file a plan during the first 120 days of a Chapter 11 bankruptcy case. The bankruptcy court may, however, extend or reduce that 120 day period upon timely request. Once the debtor=s exclusivity period expires, any creditor or other party in interest may file a plan. Normally, the debtor negotiates the terms of the plan of reorganization with representatives of its creditors before it files the plan. A plan may provide for the full payment of a creditors, partial payment of creditors, the conversion of all or part of the debt of the debtor into stock or other equity of the debtor or a third party, or any other type of arrangement which is acceptable to the creditors of the debtor. A plan may also provide for the orderly liquidation of the debtor.

Section 1123(a) sets forth the provisions which every plan must contain. Included in these provisions are the requirements that a debtor must designate classes of claims or interests, indicate whether each class is impaired or unimpaired, and if such class is impaired the treatment it will receive under the plan, provide the same treatment for all members of a class of claims or interests, except to the extent that the holder of a particular claim or interest agrees to accept less favorable treatment, and provide adequate means for the plan=s implementation. Section 1123(b) includes optional provisions a plan may contain while section 1129 of the Bankruptcy Code contains the requirements for confirmation of the plan of reorganization.

Once a plan has been filed, and before votes of creditors can be solicited, a disclosure statement, which has been approved by the bankruptcy court, must be provided to all holders of claims or interests in the debtor=s estate. A disclosure statement must set forth the terms of the plan, as well as sufficient information to allow the holders of claims and interests to make an informed decision whether to vote for or against the plan. Once the disclosure statement is approved by the Bankruptcy Court, the disclosure statement, the plan and a ballot will be sent to the creditors and other parties in interest. Section 1125 of the Bankruptcy Code governs the post-petition disclosure and solicitation of a plan.

Section 1123 specifically contemplates classifying each creditor and/or interest holder into a class in accordance with the provisions of section 1122. Only similar claims may be placed in the same class. Normally, secured creditors are classified separately unless they all hold the same collateral, such as secured bondholders. Each claimant of a particular class must be treated the same.

The plan must also state whether the class of claims or interests will be impaired or unimpaired. The claim is not impaired if the plan leaves the legal, equitable and contractual rights of the claimant unaltered. In the event that a claim is impaired, the plan must set forth the treatment of that claim. Examples of treatment methods include:

1. Partial payment of the claim;

2. Payment in full or in part over time with or without interest; or

3. Conversion of the claim to an equity interest in the debtor or some third party.

Once a plan has been proposed, there are two methods by which it can be confirmed. The first is the Aacceptance@ method, in which all impaired classes of claims or interests have voted in the requisite number and amount to accept the plan. In order for a class of claims to accept the plan, votes representing at least two-thirds in amount of claims voted, and more than one-half in number of the creditors actually voting in that class must be cast for acceptance of the plan.

The second method of plan confirmation is the Anon-acceptance@ or Acramdown@ method, in which at least one class of impaired claims (but not interests) has voted in the requisite number and amount to accept the plan, and certain other requirements are met with respect to all non-consenting impaired classes of claims or interests. Cramdown may become necessary if a class of claims or interests rejects the plan.

Section 506 of the Bankruptcy Code provides that a secured claim is recognized as secured to the extent of the value of the collateral of the secured creditor.

For a plan to be confirmed, if it has not been accepted by a class of secured creditors, the plan must provide that the secured creditor retains its lien on its collateral and receives deferred cash payments with a present value of the value of the collateral. Alternatively, the collateral may be sold with the liens attaching to the proceeds of the sale. A plan may also be confirmed if it provides the secured creditor with the Aindubitable equivalent@ of its claim.

The Chapter 11 debtor=s discharge is effective upon confirmation of the plan, unless the plan provides for the liquidation of all or substantially all of the property of the estate, the debtor does not engage in business after consummation of the plan and the debtor would be denied a discharge under Section 727 of the Code if the case were a case under Chapter 7, or, in the case of an individual debtor, if a debt is excepted from discharge under section 523 of the Code.

Non-Judicial Reorganization

Some debt-laden businesses attempt to reorganize through out-of-court workouts with lenders and suppliers. If successful, these negotiations may result in the debtor=s ability to avoid bankruptcy court, and simply continue operations pursuant to the terms of the agreement. There are no specific laws governing out-of-court workouts, however, and any agreements must comply with applicable state or federal laws. Occasionally, federal equity receiverships or state court receiverships are used to reorganize businesses, but these proceedings are not widely utilized for business reorganizations

While a debtor involved in an out-of-court workout does not have the burden of complying with the terms of the Bankruptcy Code during its negotiations, it is also not afforded the protections which Chapter 11 offers, such as the section 362 automatic stay and exemption from certain securities requirements. Many times, negotiations that start as workouts often end up in bankruptcy court as pre-packaged plans. This simply means that a Chapter 11 debtor files a pre-negotiated or pre-approved plan of reorganization when the petition is filed.

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Robin Phelan is a partner in the Business Reorganization and Bankruptcy Section of Haynes and Boone. His practice is exclusively devoted to insolvency, reorganization and related areas, including extensive litigation in the bankruptcy court and other federal courts.

Phelan works with other Haynes and Boone attorneys to analyze the effect of bankruptcy on corporate and financial transactions. He has represented both debtors and creditors in all types of bankruptcy and insolvency proceedings ranging from sole proprietors to major publicly-held companies such as Zale=s, LTV, Greyhound and Fruehauf. He works with clients acquiring financially troubled businesses and has acted as an operating trustee in bankruptcy cases.

Phelan is a Past President of the American Bankruptcy Institute, former Chairperson of both the Bankruptcy Litigation Subcommittee and the Tax Subcommittee of the Business Bankruptcy Committee of the Business Law Section of the American Bar Association and is a past Chairperson of the Bankruptcy Law Committee of the Business Law Section of the State Bar of Texas. He is the former Chairperson of the Dallas Bar Association Section on Bankruptcy and Commercial Law, and an adjunct professor of Bankruptcy and Creditors' Rights at Southern Methodist University School of Law. He is a fellow of the American College of Bankruptcy and a member of the College of the State Bar of Texas. He is a frequent speaker on panels and programs throughout the United States and abroad regarding developments in bankruptcy and insolvency law and is the author of numerous publications. He is a contributor to several major treatises on bankruptcy and has testified before Congress on insolvency matters. Phelan has recently participated in a program sponsored by the United States Department of State and the United Nations to develop model cross border insolvency provisions.

Phelan earned his B.S.B.A. with a double major in accounting and finance from Ohio State University in 1967, and his law degree from Ohio State University College of Law in 1970.

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