Chapter 11 - 101

The Nuts and Bolts of Chapter 11 Practice: a primer

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About the Authors

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John D. “Jack” Ayer is an Emeritus Professor of Law at the University of California-Davis, a former bankruptcy judge, and a fellow of the American College of Bankruptcy. He is co-author (with Michael Bernstein) of ABI’s Bankruptcy in Practice and authored ABI’s Bankruptcy Overview: Issues, Law and Policy, Fifth Ed., and has written more than 50 law review articles. Prof. Ayer served as ABI’s Robert M. Zinman Resident Scholar for the spring 2006 semester.
This book collects and supplements a series of articles published in the ABI Journal in 2004 and 2005. We were gratified to hear from many judges, practitioners and professors alike who wrote to tell us that they used the articles as handouts in connection with their training and teaching efforts.

Our goal in updating and compiling the articles into this book was to craft a text that would be an easy read for new restructuring professionals as well as law students and lawyers who are not restructuring practitioners but who nonetheless want to understand the basic contours of the practice.

We acknowledge the valuable assistance in this project of H. Slayton Dabney Jr., Esquire, who read the entire manuscript and offered helpful insights and suggestions.
# Table of Contents

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 1</td>
<td>Welcome to the Jungle</td>
<td>1</td>
</tr>
<tr>
<td>Appendix 1(a)</td>
<td>Voluntary Petition</td>
<td>7</td>
</tr>
<tr>
<td>Appendix 1(b)</td>
<td>Declaration</td>
<td>11</td>
</tr>
<tr>
<td>Appendix 1(c)</td>
<td>20 Largest Claims</td>
<td>12</td>
</tr>
<tr>
<td>Appendix 1(d)</td>
<td>Schedules</td>
<td>14</td>
</tr>
<tr>
<td>Appendix 1(e)</td>
<td>Summary of Schedules</td>
<td>16</td>
</tr>
<tr>
<td>Chapter 2</td>
<td>The Life Cycle of a Chapter 11 Debtor Through the Debtor's Eyes</td>
<td>17</td>
</tr>
<tr>
<td>Chapter 3</td>
<td>What Every Secured Creditor (and Its Lawyer) Should Know About Chapter 11</td>
<td>31</td>
</tr>
<tr>
<td>Appendix 3(a)</td>
<td>In re Submicron Systems Corporation</td>
<td>40</td>
</tr>
<tr>
<td>Chapter 4</td>
<td>An Overview of the Automatic Stay</td>
<td>55</td>
</tr>
<tr>
<td>Appendix 4(a)</td>
<td>La Jolla Mortgage Fund</td>
<td>62</td>
</tr>
<tr>
<td>Chapter 5</td>
<td>An Overview of Bankruptcy Litigation</td>
<td>70</td>
</tr>
<tr>
<td>Appendix 5(a)</td>
<td>Form 16D. Caption for Use In Adversary Proceeding</td>
<td>77</td>
</tr>
<tr>
<td>Appendix 5(b)</td>
<td>Subpoena for Rule 2004 Examination</td>
<td>80</td>
</tr>
<tr>
<td>Chapter 6</td>
<td>Overview of Avoidance Actions</td>
<td>91</td>
</tr>
<tr>
<td>Appendix 6(a)</td>
<td>In Re: Icarus Holdings, LLC</td>
<td>96</td>
</tr>
<tr>
<td>Chapter 7</td>
<td>Preference Avoidance</td>
<td>105</td>
</tr>
<tr>
<td>Appendix 7(a)</td>
<td>In Re Kmart Corp</td>
<td>110</td>
</tr>
<tr>
<td>Appendix 7(b)</td>
<td>In The Matter Of: RAMBA INC</td>
<td>117</td>
</tr>
<tr>
<td>Chapter 8</td>
<td>The Trustee's Power to Avoid Fraudulent Transfers</td>
<td>130</td>
</tr>
<tr>
<td>Appendix 8(a)</td>
<td>In Re Fruehauf Trailer Corporation</td>
<td>135</td>
</tr>
<tr>
<td>Chapter 9</td>
<td>What Every Unsecured Creditor Should Know About Chapter 11</td>
<td>148</td>
</tr>
<tr>
<td>Appendix 9(a)</td>
<td>Form B10</td>
<td>154</td>
</tr>
<tr>
<td>Appendix 9(b)</td>
<td>Committee Notes</td>
<td>156</td>
</tr>
<tr>
<td>Chapter 10</td>
<td>Priorities</td>
<td>158</td>
</tr>
<tr>
<td>Appendix 10(a)</td>
<td>Priority Ladder</td>
<td>163</td>
</tr>
<tr>
<td>Chapter 11</td>
<td>Obtaining DIP Financing and Using Cash Collateral</td>
<td>164</td>
</tr>
<tr>
<td>Appendix 11(a)</td>
<td>Judge Peter J. Walsh</td>
<td>168</td>
</tr>
<tr>
<td>Appendix 11(b)</td>
<td>In re the Colad Group, Inc</td>
<td>174</td>
</tr>
<tr>
<td>Chapter 12 Bankruptcy Issues for Landlords and Tenants</td>
<td>188</td>
<td></td>
</tr>
<tr>
<td>------------------------------------------------------</td>
<td>-----</td>
<td></td>
</tr>
<tr>
<td>Appendix 12(a) In re Standor Jewelers West, Inc.</td>
<td>194</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 13 Executory Contracts and Section 365</th>
<th>198</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 13(a) In re Midwest Portland Cement Company</td>
<td>202</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 14 Confirming a Plan</th>
<th>207</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 14(a) In re Tracey Barnes, Debtor</td>
<td>212</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 15 Small Business Provisions</th>
<th>218</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 15(a) Interim Rules and Official Forms Implementing the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 Rule 1020</td>
<td>221</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 16 Non Plan Sales of a Business</th>
<th>222</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 16(a) In re FLYI, Inc.</td>
<td>225</td>
</tr>
<tr>
<td>Appendix 16(b) Guidelines for the Conduct of Asset Sales</td>
<td>229</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 17 Professional Retention and Compensation</th>
<th>241</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 17(a) In re: Congoleum Corp.</td>
<td>251</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 18 Bad Words</th>
<th>269</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 18(a) In re Tradex Corporation</td>
<td>274</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 19 Out of Court Workouts, Prepacks, and Pre-Arranged Cases: A Brief Introduction</th>
<th>287</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 19(a) Pre-Packaged Chapter 11 Guidelines</td>
<td>291</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 20 Confirmation Is Not the End of the Case</th>
<th>331</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 20(a) In Re Encompass Services</td>
<td>335</td>
</tr>
<tr>
<td>Appendix 20(b) Resorts International</td>
<td>348</td>
</tr>
<tr>
<td>Appendix 20(d) Example of Plan and Jurisdiction</td>
<td>364</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 21 Bankruptcy Appeals</th>
<th>370</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 21(a) Continental en banc Decision</td>
<td>374</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 22 Cross-Border Cases</th>
<th>397</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 22(a) Petition of Lloyd</td>
<td>399</td>
</tr>
</tbody>
</table>

| Chapter 23 Bibliography: Cases You Should Know So You Don’t Have to Pretend | 412 |
The overwhelming majority of bankruptcy cases involve debtors who have no assets to distribute to creditors and who are filing just to get the discharge. Well over a million and sometimes over two million such cases are filed each year. These are important cases for the people involved, and they provide work for a lot of lawyers. But they aren’t our department, and we won’t spend a lot of time on them. Instead, we will spend most of our time on the cases where the debtor does have assets, and where the goal is to “reorganize” (whatever that may mean—of which more will be discussed later).

Bankruptcy law is federal. It is federal because in Article 1 of the Constitution it says that Congress shall have the power to make bankruptcy law. Congress exercised the power through the Bankruptcy Reform Act of 1978 (BRA), including the Bankruptcy Code, which is codified in Title 11 of the U.S. Code. The bankruptcy code was most recently amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), applicable to all cases filled after Oct. 17, 2005.

The BRA creates bankruptcy courts that operate as “a unit of” the U.S. district courts. Formally, the big distinction is in the power of the judge: the district judge exercises his judicial power under Article III of the Constitution and is a lifetime appointee, while the bankruptcy judge is a term appointee (14 years), deriving his or her power from the bankruptcy clause in Article I of the Constitution. Because the bankruptcy judges are “Article I” judges, case law holds that there must be limitations on the power of a bankruptcy judge in order for the bankruptcy system to be constitutional.

As a result, Title 28 of the U.S. Code was amended to put the bankruptcy judge under the “supervision” of the district judge: certain decisions by a bankruptcy judge must be reviewed by a district judge, and the district judge can withdraw matters that are pending before the bankruptcy judge and instead decide them herself. But practically speaking, the overwhelming majority of what happens in bankruptcy cases takes place in the bankruptcy court, under the supervision of the bankruptcy judge.

Who are the players in the bankruptcy game?

We have already mentioned the bankruptcy judge; he or she presides over the bankruptcy court. There are about 340 bankruptcy judges around the country, give or take. Some came to the bankruptcy bench with a lot of bankruptcy experience, some did not. But it may not make much difference: Lots of those without bankruptcy experience are fast learners, and some of them brought valuable experience from elsewhere—e.g., good trial skills.

As with other judges, the relationship between bankruptcy lawyers and judges is a somewhat formal one. You typically deal with them either in court, on the record or through their staff. Local practice may vary somewhat, but the chances are that the judge has a secretary, a “courtroom deputy” who manages scheduling and the flow of paper, and a law clerk. Some
bankruptcy judges have opted for two clerks and no secretary. Tastes differ on how you communicate with the court: Some want you to work through the secretary, some through the deputy and some through the law clerk.

In addition to the bankruptcy judge’s staff, bankruptcy attorneys also typically deal with the clerk of the bankruptcy court and the clerk’s staff. The clerk’s office is in charge of filing papers, assigning cases and, in some courts, scheduling matters. Because bankruptcy involves so much paperwork (and because of the high volume of cases), the clerk of the bankruptcy court plays an important role. A good clerk’s office can make the bankruptcy process work much more smoothly for the judges and the lawyers alike.

As a matter of law, the court is always open. This is why you sometimes see major bankruptcy cases filed on Sundays or holidays. The clerk will meet you there and accept the filing if necessary. This is one more good reason to develop a good working relationship with the bankruptcy clerk’s office.

In the mass of ordinary bankruptcies (the “chapter 7 cases” discussed below), the case is administered by a trustee. The trustees are selected in rotating order from a “panel” of local trustees—typically lawyers, but sometimes accountants or other financial professionals. The trustee collects and liquidates the debtor’s nonexempt assets (although, as noted above, in most cases there are not any). He is generally empowered to “police” the case. Sometimes, the trustee hires lawyers to represent him.

In chapter 13 cases, in which an individual proposes a plan to repay at least a portion of his debts over, normally, a five year period, the standing chapter 13 trustee for the district will collect and administer payments under the plan as well as participate in the administration of the case. The standing chapter 13 trustee is different than the “panel” trustees who handle chapter 7 cases.

Chapter 11 is different. There is no trustee unless the judge orders the appointment of one. In lieu of a trustee, the debtor remains in control of its business and assets as debtor-in-possession (DIP). The DIP has most of the powers and responsibilities of a trustee. There are many instances where a particular power will belong either to the trustee or to the DIP, depending on who is in charge. To simplify matters, in this book we will use “DIP” to refer to the entity in charge of the chapter 11 estate.

In the typical case, it is the debtor who initiates the bankruptcy case through its (pre-bankruptcy) lawyer. Once it has filed, the debtor—now DIP—seeks court approval to retain its lawyer as counsel for the DIP. The DIP’s counsel becomes a kind of “point person” in the chapter 11 case.

Do not confuse “case” trustees with the “United States Trustee.” The U.S. Trustee for any given “region” is the head of the Office of the U.S. Trustee (the UST) for that region. The UST is a division of the Department of Justice that is charged with oversight of the bankruptcy system. The U.S. Trustee’s Office appoints and supervises panel trustees, appoints official committees (see below), reviews and comments on applications to employ and compensate professionals,
investigates bankruptcy fraud and abuse, and can be heard on any other issue in a bankruptcy case. The UST is often active in the very early stages of a chapter 11 case, although once the case is up and running, and particularly if there is active creditor participation, the UST often backs off a bit. In two states (Alabama and North Carolina), there is a Bankruptcy Administrator rather than a UST, but the duties are essentially the same.

In large chapter 11 cases, you will also have a “committee” -- an official committee of unsecured creditors, appointed by the UST. The committee typically consists of the five or seven largest unsecured creditors that are willing to serve. It hires counsel (and sometimes financial advisors or other professionals) who are paid for by the debtor’s estate. The committee has standing to be heard on any issue in a chapter 11 case, and its views tend to be taken seriously by the bankruptcy judges. An active and well-represented committee can play a major role in the outcome of the case. In some cases, other official committees will also be appointed, such as equity-holder committees, retiree committees, bondholder committees, etc. Unofficial committees, neither appointed by the U.S. Trustee nor necessarily paid for by the estate, may also form and be active in a case.

Other important players include secured parties, especially banks, that may have liens on substantially all of a debtor’s assets, and counter-parties to executory contracts. Due to the nature of modern business financing, secured creditors are extremely important to the process, and without their consent and cooperation many chapter 11 debtors are forced to shut their doors.

Now, a word about the structure of the Code. As we said above, the Bankruptcy Code is in Title 11 of the U.S. Code and is divided into chapters. Chapters 1, 3 and 5 are “general” chapters, applicable in all cases:

- Chapter 1 contains definitions, delineates who can be a debtor, describes the courts’ powers and contains some other general rules.
- Chapter 3 governs “case administration,” including matters such as the filing of new cases, employment of professionals, the automatic stay, the use, sale and lease of estate assets, post-petition financing, executory contracts, the dismissal and closing of cases, and some other matters.
- Chapter 5 covers a wide variety of matters relating to the rights of debtors and creditors, including claims and priorities, matters relating to exemptions and discharge of debts, and the “avoidance” provisions, which permit a DIP to claw back certain transfers made prior to the petition date.

Chapter 7 provides additional rules for cases in which a trustee liquidates the assets. Both individuals and business entities can be chapter 7 debtors. Corporate chapter 7 debtors are just liquidated and do not get a discharge (they don’t really need one; liquidated corporations are not usually attractive defendants). Individual chapter 7 debtors turn over their nonexempt assets (if any) to the trustee, and then ordinarily get a discharge, which covers most (but not all) kinds of debts. Earnings from personal services do not become part of the bankruptcy estate in chapter 7.
Chapter 13 provides additional rules for cases in which the debtor agrees to submit a portion of his post-petition earnings to pay pre-petition debts. In return he gets protection against creditor action, and a chance to restructure some of his pre-bankruptcy debts. Probably most chapter 13s are filed by individuals seeking to protect their homes against the threat of a mortgage foreclosure. Others are filed by debtors with assets that they would lose in chapter 7, but that they may keep if they carry out a chapter 13 plan. Chapter 13 debtors also get to discharge some debts that might not be dischargeable in chapter 7, although the chapter 13 discharge isn’t as broad as it was before the BAPCPA amendments, and it probably isn’t a factor in most chapter 13 filings. Due to the fact that under a chapter 13 plan, the debtor’s finances (other than those necessary for basic life expenses) are devoted to plan payments, any substantial negative economic event—such as being injured and unable to work or losing a job—is likely to cause a default under the plan and a conversion of the case to chapter 7.

Chapter 11, entitled “reorganization,” is the chapter that provides additional rules for the small number of “big” business reorganizations that entail a lot of lawyer time and effort, and generate a lot of professional fees. If you ask a chapter 11 lawyer what it means to reorganize, she will likely say something like this: A chapter 11 case allows the debtor to preserve the business as a going concern, and thereby to maximize value for creditors, shareholders, employees and other stakeholders.

This is a beguiling picture and not entirely true; there are all kinds of difficulties:

- The most obvious is that not all businesses are worth more as a going concern than they are in liquidation. A notorious example is the case of the Penn Central Railroad, one of the largest bankruptcies in American history. Penn Central went into bankruptcy as an unprofitable network of railroads, then emerged as a valuable real estate company.

- A second difficulty is that chapter 11 specifically provides that a reorganization plan may provide for the liquidation of some or all of the debtor’s assets—so chapter 11 is not only about reorganization, and the Code implicitly recognizes that in some cases value is maximized through liquidation.

- Third, the debtor does not need to choose chapter 11 if he wants the business to continue; the trustee may, with court approval, continue to operate the business in chapter 7 (although it is not often done).

- Fourth, the distinction between “liquidation” and “going concern” may be less clear in practice than it is in theory. One can perfectly well “liquidate” a business by selling it as a going concern, in which case the distinction does not mean anything at all. Indeed, the “going concern” sale is a popular trend these days.

- Finally, bankruptcy law conflates two concepts that are overlapping but fundamentally quite different. One is the notion of maximizing the value of the assets. The other is the notion of saving the residual stake of the pre-bankruptcy owners. This confusion is apparent in the classic chapter 11 case. The old residual
owners (equity-holders), still in control of the enterprise, will file the petition. They will remain in control (as DIP) and will propose “a plan” to “save the going concern.” If all goes well, the effect will be to maximize the payout to creditors and to leave something on the table for the owners (while preserving jobs, generating future tax revenues and serving other social goods that are often touted as benefits of reorganization). Such a scenario appears to be a self-evident win-win situation. But it is rarely that simple. “Saving the going concern” means continuing the business, which means continuing to bear risk. Where the business is insolvent, equity always gains from taking risks: Liquidate today, and they get nothing; keep the business going, and they may have a chance. Creditors tend to be correspondingly risk-averse: Liquidate today, and they get paid. Take a gamble, and the rewards go to equity, while the creditors bear the risk of loss. The point is not that creditors always favor liquidation—clearly, they don’t—but the risk-reward calculation is different for creditors than it is for equity-holders (and it is similarly different for junior creditors than it is for senior creditors). There can be no doubt that chapter 11 obscures, rather than resolves, this tension—almost as if deliberately to allow the court to choose, from case to case and even from time to time within a case, whether “assets” or “equity” will dominate.

Aside from chapters 7, 11 and 13, there are a couple of other chapters for particular kinds of cases. Chapter 9 is for municipalities (the cases are few in number, but sometimes notorious). Chapter 12 is for “family farmers or fishermen” (but plenty of farmers and fishermen use chapters 11 or 7). A new “chapter 15” governs cross-border insolvencies. It isn’t really a full-dress bankruptcy device like the other chapters: rather it is a mechanism for orchestrating the competition between jurisdictions. It supplants former §304.

Aside from the Code, there are other places to look for bankruptcy law. The jurisdiction provisions are in Title 28 of the Judicial Code. There are some provisions on bankruptcy crimes in Title 18, the Federal Criminal Code. There is some bankruptcy tax law in Title 26, the Internal Revenue Code.

But there is still more law. In a great many cases, the bankruptcy court is adjudicating rights that involve “other law”—e.g., the nonbankruptcy law of property. So, the bankruptcy lawyer may have to be an expert, or at least versed, at this other law. At a minimum, he needs to be able to spot the issues and know when to call in the specialists. In any particular case, this can mean anything. Most often, it means nonbankruptcy debtor-creditor and commercial law, notably Article 9 of the Uniform Commercial Code (secured transactions in personal property) and nonbankruptcy mortgage law.¹

Aside from the statutes, there is a set of Federal Rules of Bankruptcy Procedure, a cousin to the Federal Rules of Civil Procedure. And bankruptcy courts also have their own local rules,

¹ Look for the regular column Chapter 11-201 in the ABI Journal for more on this interplay between bankruptcy law and other areas of the law.
which should be (but are not always) consistent with the more general bankruptcy rules. Most bankruptcy courts have *Web sites*, and the local rules are generally available on the *Web sites*. The official forms can be found at http://www.uscourts.gov, some are included in the appendix to this chapter.

One final note: on April 20, 2005, the President signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Public Law 109-8, *119 Stat. 23*, which made the most wide ranging and substantial changes to the Bankruptcy Codes since it was enacted in 1978. In this book, that act is referred to as BAPCPA and citations to it or its effects on the Code are given to the Code section, not the original BAPCPA provision.
APPENDIX 1(a)
VOLUNTARY PETITION
## United States Bankruptcy Court

### Voluntary Petition

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<tr>
<th>Name of Debtor (if individual, enter Last, First, Middle):</th>
<th>Name of Joint Debtor (Spouse) (Last, First, Middle):</th>
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<th>All Other Names used by the Debtor in the last 8 years (include married, maiden, and trade names):</th>
<th>All Other Names used by the Joint Debtor in the last 8 years (include married, maiden, and trade names):</th>
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<tr>
<th>Last four digits of Soc. Sec./Complete EIN or other Tax I.D. No. (if more than one, state all):</th>
<th>Last four digits of Soc. Sec./Complete EIN or other Tax I.D. No. (if more than one, state all):</th>
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<tr>
<th>Street Address of Debtor (No. &amp; Street, City, and State):</th>
<th>Street Address of Joint Debtor (No. &amp; Street, City, and State):</th>
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<tr>
<th>County of Residence or of the Principal Place of Business:</th>
<th>County of Residence or of the Principal Place of Business:</th>
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<tr>
<th>Mailing Address of Debtor (if different from street address):</th>
<th>Mailing Address of Joint Debtor (if different from street address):</th>
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<tr>
<th>Location of Principal Assets of Business Debtor (if different from street address above):</th>
<th>ZIPCODE</th>
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### Type of Debtor (Form of Organization)

- [ ] Individual (includes Joint Debtor)
- [ ] Corporation (includes LLC and LLP)
- [ ] Partnership
- [ ] Other (if debtor is not one of the above entities, check this box and provide the information requested below)

#### State type of entity:

**Nature of Business**

(Choose all applicable boxes.)

- [ ] Health Care Business
- [ ] Single Asset Real Estate as defined in 11 U.S.C. § 101(51B)
- [ ] Railroad
- [ ] Stockbroker
- [ ] Commodity Broker
- [ ] Clearing Bank

### Chapter of Bankruptcy Code Under Which the Petition Is Filed

(Choose one box)

- [ ] Chapter 7
- [ ] Chapter 11
- [ ] Chapter 13
- [ ] Chapter 15 Petition for Recognition of a Foreign Main Proceeding
- [ ] Chapter 15 Petition for Recognition of a Foreign Nonsingular Proceeding

**Nature of Debts (Check one box):**

- [ ] Consumer/Non-Business
- [ ] Business

#### Chapter 11 Debtors

(Choose one box)

- [ ] Debtor is a small business debtor as defined in 11 U.S.C. § 101(51D).
- [ ] Debtor is not a small business debtor as defined in 11 U.S.C. § 101(51D)

**Check if:**

- [ ] Debtor's aggregate noncontingent liquidated debts owed to non-insiders or affiliates are less than $2 million.

### Statistical/Administrative Information

- [ ] Debtor estimates that funds will be available for distribution to unsecured creditors.
- [ ] Debtor estimates that, after payment of administrative expenses paid, there will be no funds available for distribution to unsecured creditors.

#### Estimated Number of Creditors

- [ ] 1-49
- [ ] 50-99
- [ ] 100-199
- [ ] 200-999
- [ ] 1,000-5,000
- [ ] 5,001-10,000
- [ ] 10,001-25,000
- [ ] 25,001-50,000
- [ ] 50,001-100,000
- [ ] OVER 100,000

#### Estimated Assets

| $0 to $50,000 | $50,001 to $100,000 | $100,001 to $500,000 | $500,001 to $1,000,000 | $1,000,001 to $2,500,000 | $2,500,001 to $5,000,000 | $5,000,001 to $10,000,000 | $10,000,001 to $15,000,000 | $15,000,001 to $20,000,000 | $20,000,001 to $25,000,000 | $25,000,001 to $30,000,000 | $30,000,001 to $50,000,000 | $50,000,001 to $75,000,000 | $75,000,001 to $100,000,000 | $100,000,000 to $150,000,000 | $150,000,000 to $200,000,000 | $200,000,000 to $250,000,000 | $250,000,000 to $300,000,000 | $300,000,000 to $500,000,000 | $500,000,000 to $750,000,000 | $750,000,000 to $1,000,000,000 | More than $1,000,000,000 |
|--------------|---------------------|---------------------|------------------------|-------------------------|-------------------------|---------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| [ ]          | [ ]                 | [ ]                 | [ ]                    | [ ]                     | [ ]                     | [ ]                        | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         |

#### Estimated Debts

| $0 to $50,000 | $50,001 to $100,000 | $100,001 to $500,000 | $500,001 to $1,000,000 | $1,000,001 to $2,500,000 | $2,500,001 to $5,000,000 | $5,000,001 to $10,000,000 | $10,000,001 to $15,000,000 | $15,000,001 to $20,000,000 | $20,000,001 to $25,000,000 | $25,000,001 to $30,000,000 | $30,000,001 to $50,000,000 | $50,000,001 to $75,000,000 | $75,000,001 to $100,000,000 | $100,000,000 to $150,000,000 | $150,000,000 to $200,000,000 | $200,000,000 to $250,000,000 | $250,000,000 to $300,000,000 | $300,000,000 to $500,000,000 | $500,000,000 to $750,000,000 | $750,000,000 to $1,000,000,000 | More than $1,000,000,000 |
|--------------|---------------------|---------------------|------------------------|-------------------------|-------------------------|---------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| [ ]          | [ ]                 | [ ]                 | [ ]                    | [ ]                     | [ ]                     | [ ]                        | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         | [ ]                         |

### Appendix 1(a) - Voluntary Petition

8

**Chapter 11-101**
### Prior Bankruptcy Case Filed Within Last 8 Years

<table>
<thead>
<tr>
<th>Location</th>
<th>Case Number</th>
<th>Date Filed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Where Filed:</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Pending Bankruptcy Case Filed by any Spouse, Partner or Affiliate of this Debtor

<table>
<thead>
<tr>
<th>Name of Debtor:</th>
<th>Case Number:</th>
<th>Date Filed:</th>
</tr>
</thead>
</table>

### Exhibit A

(To be completed if debtor is an Individual or a business entity)

- Exhibit A is attached and made a part of this petition.

### Exhibit B

(To be completed if debtor is an Individual or a business entity)

- The attorney for the petitioner named in the foregoing petition, declare that I have informed the petitioner that [he or she] may proceed under chapter 7, 11, 12, or 13 of title 11, United States Code, and have explained the relief available under such chapters.

- I further certify that I delivered to the debtor the notice required by § 342(b) of the Bankruptcy Code.

### Exhibit C

Does the debtor own or have possession of any property that poses or is alleged to pose a threat of imminent and identifiable harm to public health or safety?

- Yes
- No

### Certification Concerning Debt Counseling

- I owe have received approved budget and credit counseling during the 180-day period preceding the filing of this petition.
- I owe request a waiver of the requirement to obtain budget and credit counseling prior to filing based on exigent circumstances. (Must attach certification describing.)

### Information Regarding the Debtor (Check the Applicable Boxes)

- Debtor has been domiciled or has had a residence, principal place of business, or principal assets, in this District for 180 days immediately preceding the date of this petition or for a longer part of such 180 days than in any other District.
- There is a bankruptcy case concerning debtor’s affiliate, general partner, or partnership pending in this District.
- Debtor is a debtor in a foreign proceeding and has its principal place of business or principal assets in the United States in this District, or has no principal place of business or assets in the United States but is a defendant in an action or proceeding [in a federal or state court] in this District, or the interest of the parties will be served in regard to the relief sought in this District.

### Statement by a Debtor Who Resides as a Tenant of Residential Property

- Landlord has a judgment against the debtor for possession of debtor’s residence. (If box checked, complete the following.)

  (Name of landlord that obtained judgment)

  (Address of landlord)

- Debtor claims that under applicable non-bankruptcy law, there are circumstances under which the debtor would be permitted to cure the entire monetary default that gave rise to the judgment for possession, after the judgment for possession was entered, and
- Debtor has included in this petition the deposit with the court of any rent that would become due during the 30-day period after the filing of the petition.
### Signatures

**Signature(s) of Debtor(s) (Individual/Joint)**

I declare under penalty of perjury that the information provided in this petition is true and correct.

If petitioner is an individual whose debts are primarily consumer debts and has chosen to file under chapter 7, I am aware that I may proceed under chapter 7, 11, 12 or 13 of title 11, United States Code, understand the relief available under each such chapter, and choose to proceed under chapter 7. (If no attorney represents me and no bankruptcy petition preparer signs the petition) I have obtained and read the notice required by § 342(b) of the Bankruptcy Code.

I request relief in accordance with the chapter of title 11, United States Code, specified in this petition.

X ______________________
Signature of Debtor

X ______________________
Signature of Joint Debtor

**Telephone Number (If not represented by attorney)**

Date ______________________

---

**Signature of Attorney**

X ______________________
Signature of Attorney for Debtor(s)

**Printed Name of Attorney for Debtor(s)**

**Firm Name**

**Address**

Date ______________________

---

**Telephone Number**

Date ______________________

---

**Signature of Debtor (Corporation/Partnership)**

I declare under penalty of perjury that the information provided in this petition is true and correct, and that I have been authorized to file this petition on behalf of the debtor.

The debtor requests relief in accordance with the chapter of title 11, United States Code, specified in this petition.

X ______________________
Signature of Authorized Individual

**Printed Name of Authorized Individual**

**Title of Authorized Individual**

Date ______________________

---

**Signature of a Foreign Representative**

I declare under penalty of perjury that the information provided in this petition is true and correct, that I am the foreign representative of a debtor in a foreign proceeding, and that I am authorized to file this petition.

(Attach only one box)

☐ I request relief in accordance with chapter 15 of title 11, United States Code. Certified copies of the documents required by § 1515 of title 11 are attached.

☐ Pursuant to § 1511 of title 11, United States Code, I request relief in accordance with the chapter of title 11 specified in this petition. A certified copy of the order granting recognition of the foreign main proceeding is attached.

X ______________________
Signature of Foreign Representative

(Printed Name of Foreign Representative)

Date ______________________

---

**Signature of Non-Attorney Bankruptcy Petition Preparer**

I declare under penalty of perjury that: (1) I am a bankruptcy petition preparer as defined in 11 U.S.C. § 110; (2) I prepared this document for compensation and have provided the debtor with a copy of this document and the notice and information required under 11 U.S.C. §§ 1100(b), 1102(b), and 342(b); and, (3) if rules or guidelines have been promulgated pursuant to 11 U.S.C. § 1102(b) setting a maximum fee for services chargeable by bankruptcy petition preparers, I have given the debtor notice of the maximum amount before preparing any document for filing for a debtor or accepting any fee from the debtor, as required in that section. Official Form 19B is attached.

**Printed Name and title, if any, of Bankruptcy Petition Preparer**

Social Security number (If the bankruptcy petition preparer is not an individual, state the Social Security number of the officer, principal, responsible person or partner of the bankruptcy petition preparer; Required by 11 U.S.C. § 110.)

**Address**

Date ______________________

---

**Signature of Bankruptcy Petition Preparer or officer, principal, responsible person, or partner whose social security number is provided above.**

Names and Social Security numbers of all other individuals who prepared or assisted in preparing this document unless the bankruptcy petition preparer is not an individual:

If more than one person prepared this document, attach additional sheets conforming to the appropriate official form for each person.

A bankruptcy petition preparer's failure to comply with the provisions of title 11 and the Federal Rules of Bankruptcy Procedure may result in fines or imprisonment or both 11 U.S.C. §110; 18 U.S.C. §156.
Appendix 1(b)

DECLARATION

DECLARATION UNDER PENALTY OF PERJURY
ON BEHALF OF A CORPORATION OR PARTNERSHIP

I, [the president or other officer or an authorized agent of the corporation] [or a member or an authorized agent of the partnership] named as the debtor in this case, declare under penalty of perjury that I have read the foregoing [list or schedule or amendment or other document (describe)] and that it is true and correct to the best of my information and belief.

Date ______________________________

Signature ____________________________

(Print Name and Title)
APPENDIX 1(c)
20 LARGEST CLAIMS
United States Bankruptcy Court  
District Of  

In re  .  
Debtor  

Case No.  
Chapter  

LIST OF CREDITORS HOLDING 20 LARGEST UNSECURED CLAIMS

Following is the list of the debtor’s creditors holding the 20 largest unsecured claims. The list is prepared in accordance with Fed. R. Bankr. P. 1007(d) for filing in this chapter 11 [or chapter 9] case. The list does not include (1) persons who come within the definition of “insider” set forth in 11 U.S.C. § 101, or (2) secured creditors unless the value of the collateral is such that the unsecured deficiency places the creditor among the holders of the 20 largest unsecured claims. If a minor child is one of the creditors holding the 20 largest unsecured claims, indicate that by stating “a minor child” and do not disclose the child’s name. See 11 U.S.C. § 112: Fed. R. Bankr. P. 1007(m).

<table>
<thead>
<tr>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name of creditor and complete mailing address including zip code</td>
<td>Name, telephone number and complete mailing address, including zip code, of employee, agent, or department of creditor familiar with claim who may be contacted</td>
<td>Nature of claim (trade debt, bank loan, government contract, etc.)</td>
<td>Indicate if claim is contingent, unliquidated, disputed or subject to setoff</td>
<td>Amount of claim (if secured also state value of security)</td>
</tr>
</tbody>
</table>

Date:  

Debtor  

[Declaration as in Form 2]
FORM 6. SCHEDULES

Summary of Schedules
Statistical Summary of Certain Liabilities

Schedule A - Real Property
Schedule B - Personal Property
Schedule C - Property Claimed as Exempt
Schedule D - Creditors Holding Secured Claims
Schedule E - Creditors Holding Unsecured Priority Claims
Schedule F - Creditors Holding Unsecured Nonpriority Claims
Schedule G - Executory Contracts and Unexpired Leases
Schedule H - Codebtors
Schedule I - Current Income of Individual Debtor(s)
Schedule J - Current Expenditures of Individual Debtor(s)

Unsworn Declaration under Penalty of Perjury

GENERAL INSTRUCTIONS: The first page of the debtor’s schedules and the first page of any amendments thereto must contain a caption as in Form 16B. Subsequent pages should be identified with the debtor’s name and case number. If the schedules are filed with the petition, the case number should be left blank.

Schedules D, E, and F have been designed for the listing of each claim only once. Even when a claim is secured only in part or entitled to priority only in part, it still should be listed only once. A claim which is secured in whole or in part should be listed on Schedule D only, and a claim which is entitled to priority in whole or in part should be listed on Schedule E only. Do not list the same claim twice. If a creditor has more than one claim, such as claims arising from separate transactions, each claim should be scheduled separately.

Review the specific instructions for each schedule before completing the schedule.
# Appendix 1(e) - Summary of Schedules

## United States Bankruptcy Court

---

**In re** __________________________
**Debtor**

**Case No.** __________________________

**Chapter** ____________

---

## Summary of Schedules

Indicate as to each schedule whether that schedule is attached and state the number of pages in each. Report the totals from Schedules A, B, D, E, F, I, and J in the boxes provided. Add the amounts from Schedules A and B to determine the total amount of the debtor's assets. Add the amounts of all claims from Schedules D, E, and F to determine the total amount of the debtor's liabilities. Individual debtors must also complete the "Statistical Summary of Certain Liabilities."

## AMOUNTS SCHEDULED

<table>
<thead>
<tr>
<th>NAME OF SCHEDULE</th>
<th>ATTACHED (YES/NO)</th>
<th>NO. OF SHEETS</th>
<th>ASSETS</th>
<th>LIABILITIES</th>
<th>OTHER</th>
</tr>
</thead>
<tbody>
<tr>
<td>A - Real Property</td>
<td></td>
<td></td>
<td>$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B - Personal Property</td>
<td></td>
<td></td>
<td>$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C - Property Claimed as Exempt</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D - Creditors Holding Secured Claims</td>
<td></td>
<td></td>
<td>$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E - Creditors Holding Unsecured Priority Claims</td>
<td></td>
<td></td>
<td>$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F - Creditors Holding Unsecured Nonpriority Claims</td>
<td></td>
<td></td>
<td>$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>G - Executory Contracts and Unexpired Leases</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>H - Codetitors</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I - Current Income of Individual Debtor(s)</td>
<td></td>
<td></td>
<td>$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>J - Current Expenditures of Individual Debtor(s)</td>
<td></td>
<td></td>
<td>$</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**TOTAL**

$ $
CHAPTER 2
THE LIFE CYCLE OF A CHAPTER 11 DEBTOR THROUGH THE DEBTOR’S EYES

We continue in this chapter our broad brush overview of the buffet. We’ll get back in line and sample each dish in subsequent chapters.

The chapter 11 process may be conceptualized as consisting of a number of distinct but overlapping stages. The paradigm is imperfect, and the order in which the stages come can be different, but thinking about a hypothetical chapter 11 case in this way is a useful device.

Think of a case as having four stages:

- The first stage is the period of preparation by the debtor and its professionals for the chapter 11 filing. This is sometimes referred to as “contingency planning” because options other than a chapter 11 filing are pursued while the bankruptcy preparation ensues and potential debtors often end up not filing for bankruptcy due to the implementation of one of these other options.

- The second stage consists of the first days and weeks of the bankruptcy case. These days are full of activity and occupy a great deal of management’s time and a great number of lawyer hours.

- The third stage is the “middle” of the chapter 11 case. This can be a relatively slower period of activity, in which a debtor’s management typically can focus on business operations again. But because of the restrictions placed on a debtor by the bankruptcy laws, chapter 11 is never completely “business as usual.” A debtor must still consult with counsel on a myriad of issues, and will spend a lot of time negotiating, perhaps litigating, with interested parties.

- The fourth stage is the rest of the case. Most of the activity in this stage relates to the exit from chapter 11, usually either by a reorganization plan or by sale of assets.
Preparation Stage

A chapter 11 case brings with it certain important protections that arise immediately upon the filing of the petition, most notably the automatic stay of §362. However, with these statutory protections come restrictions that limit a debtor’s unfettered discretion to operate without court approval.

Debtor’s counsel typically seeks a number of orders in the first days of the case in an effort to minimize the disruption caused by chapter 11. Certain of these “first-day orders,” as they are called, are designed to override statutory prohibitions of the Bankruptcy Code. For example, the Code generally prohibits a debtor from paying any pre-petition debts, so a debtor may file a motion seeking permission to pay pre-petition employee wages or pre-petition claims of critical trade vendors.

Other first-day orders are sought to take advantage of powers uniquely given to a debtor in bankruptcy. For example, a motion to reject executory contracts may be filed as a first-day motion.

Yet other first-day orders must be procured either out of administrative necessity or to seek modification of specific Bankruptcy Code requirements. Examples include applications to retain professionals, motions to jointly administer related cases, and motions to maintain current bank accounts and cash-management procedures.
Finally, debtors will often file first-day motions to assure the availability of cash, including a motion for authority to use a secured creditor’s “cash collateral” and a motion for approval of post-petition financing. The relief that debtors request on the first day varies depending on the debtor’s needs and the willingness of the court to grant the kinds of relief the debtor would like to have.

The drafting of first-day motions is typically preceded by a period of due diligence by debtor’s counsel. Counsel must establish contact with the appropriate employees of the debtor, and measures must be implemented to ensure confidentiality of the bankruptcy-related discussions.

At this early stage in the bankruptcy preparation process, a great deal of discretion must be exercised because often only a limited group of the debtor’s employees are aware that a bankruptcy filing may be imminent. If word of an impending bankruptcy filing leaks out, it can lead to serious adverse consequences—vendors may cease shipping, other creditors may seek to exercise remedies, competitors may seek to take away business, customers may look elsewhere, and employees may hit the street looking for a more secure job. As a result, the employees who are best equipped to provide the lawyers with the information they need are sometimes unavailable. More generally, a debtor may be operating with a significantly reduced workforce, further limiting the debtor’s resources available to assist in preparing for bankruptcy.

The First Days of a Case

A chapter 11 case may be commenced on a voluntary or involuntary basis. A company (or individual, but for ease, we say “company” throughout) commences a voluntary chapter 11 case by paying the requisite filing fee and filing a petition for relief with the clerk of a bankruptcy court. A company may file its bankruptcy case in the jurisdiction in which it is incorporated, where it has maintained a residence, principal place of business, or principal assets for at least 180 days, or where the bankruptcy case of an affiliate is already pending. Upon the filing of a voluntary petition, the company becomes a “debtor,” and its board of directors and management will continue in place as the DIP until the debtor’s plan of reorganization is confirmed, the debtor’s case is dismissed or converted to a chapter 7, or a chapter 11 trustee is appointed.

The first-day motions are typically filed at the same time the bankruptcy petition is filed. Sometimes these motions are actually heard on the first day, but more often within the first couple of days. Many first-day motions are true emergencies, but some are not. It is good practice to call something an “emergency” only if it really is one; the “first-day hearing” is counsel’s first chance to gain—or lose—credibility with the judge, and that credibility is your—and perhaps your client’s—greatest asset.

The first days of a case can be quite time-consuming for a debtor’s management. To begin with, representatives of the debtor must be present at the hearings on the first-day motions. Moreover, inquiries from customers, suppliers, creditors, investors, employees and sometimes the media abound. At the same time, the debtor must meet with the UST, comply with a host of
administrative requirements and work on the preparation of a set of bankruptcy schedules that, in even a small case, can be a substantial undertaking.

Shortly after the bankruptcy filing, the UST will usually appoint a creditors’ committee and sometimes other committees to represent the interests of creditors and/or other stakeholders. These committees may consult with the debtor on the administration of the case, investigate the conduct of the debtor and the operation of the business, and participate in the formation of a reorganization plan. In addition, a creditors’ committee may, with the court’s approval, hire an attorney and/or other professionals to assist in the performance of the committee’s duties.

Protracted negotiations with the committees are typical. The early days of the case provide the debtor with an opportunity to educate the committee and its counsel, and to develop a working relationship with the committees. This can be a key to success in chapter 11.

Early negotiations with other major creditors is also typical—particularly with major pre-petition secured lenders. If the debtor requires post-petition financing, it will also spend a lot of time early in the case (and indeed, pre-petition) with its post-petition lenders, which may be the same entities that loaned it money pre-petition, or perhaps be new lenders.

Immediately upon filing, the debtor and everyone that deals with the debtor become subject to the rules of the Bankruptcy Code, which include the following.

**The Automatic Stay**

The commencement of a bankruptcy case triggers an “automatic stay,” which, with certain exceptions, operates as an injunction against actions affecting the debtor or its property. The automatic stay provides a respite for the debtor and also protects the creditors as a group by bringing to a halt actions by individual creditors to obtain satisfaction of their claims using remedies generally available under state law.

The automatic stay usually does not protect parties who are not themselves in bankruptcy, such as guarantors or co-obligors. (There are limited exceptions to this in §§1201 and 1301, but they apply only in chapters 12 and 13). On occasion, a judge will be willing to extend the automatic stay to a non-debtor in a chapter 11 case, but those instances are not common.

Moreover, the Bankruptcy Code also expressly carves out a number of exceptions to the scope of the automatic stay, which are listed in §362(b). A creditor may seek relief from the automatic stay. The standards for obtaining relief are set forth in §362(d).

**Use, Sale or Lease of Property of the Estate**

The debtor may use, sell or lease its property in the ordinary course of its business without authorization from the bankruptcy court. However, the use, sale or disposition of any property outside the ordinary course of business requires court approval. The ordinary course of business has two dimensions—ordinary for the debtor and ordinary for businesses like the debtor. For example, a retail debtor can sell its inventory to retail customers without court
approval, but if it wants to sell whole stores or enter into major new leases, it will require court approval. There are closer calls, of course, and sometimes a debtor will seek court permission “just to be safe.” Bankruptcy Code §363 and interpretive cases govern this inquiry.

New Credit

Some debtors have enough unencumbered cash to enable them to operate in chapter 11 without new cash infusions. Even these, however, must usually rely on cash that is subject to a lender’s security interest, referred to as “cash collateral.” In order to use cash collateral, a debtor must obtain agreement of the secured party or court authorization. If the creditor does not consent to the use of its cash collateral, then the debtor must provide “adequate protection” to the lender—essentially, the debtor must compensate the creditor in some way for the use of its cash collateral or show that the collateral’s value will not diminish to an unacceptably low level through the proposed use. All of this is laid out in a relatively straightforward manner in §363, and is discussed in more detail in chapter 16 of this book.

However, many debtors cannot survive even with use of cash collateral. Instead, a debtor may require a line of credit or other post-petition financing. Bankruptcy Code §364 permits a debtor to borrow funds and offers protections and priorities to induce lenders to make these loans, which are referred to as debtor-in-possession loans or simply “DIP loans.”

These inducements are offered to lenders because, without them, lenders might be unwilling to loan money to a bankrupt company, or at least the cost of borrowing would be much higher. The inducements consist of a steadily increasing series of liens and priorities:

- The first is ordinary administrative priority.
- Second is priority over other administrative expenses (so-called “super-priority”).
- Third is a lien on unencumbered assets.
- And finally, if the debtor cannot get financing on any other terms, the court may authorize a lien that is equal to, or even senior to, other liens on estate assets. While intuitively it may seem a risky proposition to lend to a company in bankruptcy, because of the incentives and protections provided by the Bankruptcy Code to DIP lenders, it is often a very safe proposition for DIP lenders, provided that they properly take advantage of the protections offered in §364. And it can be a profitable business, since these loans often come with hefty fees.

Executory Contracts and Leases

The Bankruptcy Code contains no precise definition of an “executory contract.” As a general matter, an executory contract is one in which performance remains due to some extent on both sides (for instance, ongoing leases or supply agreements). Bankruptcy Code §365 provides the debtor with tremendous flexibility regarding these types of ongoing agreements. They can be assumed and performed by the debtor, assigned to a third party (in most cases) or rejected. By
assuming (or assigning) a contract, the debtor binds itself (or its assignee) and all other contracting parties to perform the contract fully in accordance with its original terms. Rejection of a contract constitutes a breach of the contract and entitles the non-debtor party to a claim against the estate.

Although the debtor can generally assume or reject any contract, it can not unilaterally modify one. Rather, if it wants to modify it must negotiate with the other party for desired changes against the back drop of the alternatives of eventual assumption or rejection. The decision to assume, assume and assign, or reject a contract requires court approval, but courts typically defer to the debtor’s business judgment. Until a contract is assumed or rejected, both the debtor and the non-debtor party are generally obligated to perform under it.

As a general rule, a debtor is not obligated to make the decision to assume, assign or reject until the confirmation of a plan. A party bound under a contract or lease with a debtor may, however, successfully move for an earlier deadline, if it can show that the delayed decision would prejudice it in some significant way. There is an exception for commercial real estate cases: there, the debtor gets no more than 210 days.

For public policy reasons (or as a result of special interest pressure), the Bankruptcy Code contains provisions that deal with certain types of executory contracts, including leases of commercial real estate, shopping center leases, aircraft leases and financing agreements, timeshare contracts, commitments to maintain the capital of a federally insured bank and intellectual property licenses. Although each special provision is different, the general effect of each set of rules is to restrict the debtor’s rights and increase the protections afforded to the non-debtor party to the contract.

The “Middle” of the Case

Activity in a chapter 11 case often slows down a bit after the first few weeks. Business operations tend to normalize, and the debtor is in many ways able to conduct “business as usual.” However, in addition to running its business, the debtor must comply with the various obligations bankruptcy law imposes, and must remain cognizant of deadlines imposed by the Bankruptcy Code and Rules. There will be disclosure obligations, less confidentiality, and more public scrutiny than before bankruptcy. Various constituencies will feel free to comment on what the debtor should or should not be doing and to attempt to second-guess decisions that outside of bankruptcy would be within the sole purview of management. And the debtor will have to obtain court approval for some acts that it previously could undertake in its discretion. So, “business as usual” is relative.

Early in the “middle” of the case, the debtor must attend a “first meeting of creditors” (also referred to as a “341 meeting” because of the Code section that requires the meeting to occur). At this meeting, the debtor (through a representative, if it is an entity) must answer questions posed by the UST, and sometimes by creditors, under oath. Other “administrative” obligations of the debtor in the middle of the case include the filing of monthly operating reports and the payment of quarterly fees to the UST. Of course, the debtor must ordinarily comply with its nonbankruptcy obligations as well, such as filing tax returns and SEC filings.
The “middle” of the case also affords the debtor a chance to evaluate its business and legal strategies. The specifics will, of course, vary from case to case, but business strategy evaluation might include things like whether to sell or shut down stores or plants or particular business lines, whether the workforce is of optimal size, ways to reduce expenses and improve profitability, and so forth. Legal strategy will include ways to use the special powers of a debtor to enhance the estate, including assumption and rejection of contracts and actions to avoid and recover pre-petition payments.

Finally, the middle of the case will involve a lot of negotiating with players in the case, including committees, the UST, secured creditors, landlords, labor unions, government agencies, suppliers and others. Some of this negotiation will relate to exit from bankruptcy, but much of it will relate to the various interim issues that arise in every case.

Often interspersed with this negotiation is litigation over various matters, such as creditors who seek relief from the automatic stay, landlords who want the debtor to assume or reject leases, disputes over the extension of various time periods, arguments over whether creditors are receiving adequate protection, and many other issues that can arise.

Through all this, the debtor—with counsel’s assistance—must focus on the ultimate objective of the case and try not to get too distracted by the myriad issues that arise. This stage of life is, for some debtors, the beginning of the golden years, while for others it is a mid-life crisis.

The Rest of the Case

Any entity that subjects itself to chapter 11 obviously has some serious problems that need to be fixed. Broadly stated, there are two ways chapter 11 helps a debtor deal with its problems. First, it provides the debtor with a host of powers that can help it to remedy operational problems. The ability to reject executory contracts and unexpired leases is one well-known example. Second, chapter 11 enables a debtor to restructure its balance sheet to better reflect the actual—and usually diminished—ability of the business to service debt. This is accomplished through the formulation and approval—the “confirmation”—of a chapter 11 reorganization plan.

Insofar as chapter 11 often is just a matter of making a deal with various stakeholders, one may well ask, “why can’t you just do it all informally, without the cost, inconvenience and stigma of a bankruptcy case?” The answer is you can, and often you do when you don’t need to use unique “bankruptcy powers” to make an operational fix. Plenty of times a debtor and its creditors can simply make and carry out deals without court intervention, so much so that some people even refer to an out-of-court workout as a “private chapter 11.”

But chapter 11 does permit you to accomplish some purposes that you may not be able to achieve on your own. Here are a few:

- Perhaps most important, if you get the right number of votes, you can impose the plan on dissenters (while outside of chapter 11 you may not even be able to find all of the creditors, much less get their attention or their consent).
• Because of the automatic stay, you get to hold creditors at bay while you try to make your deal.

• You get a “cleaner deal” than you may be able to get outside bankruptcy—more clarity and finality about the rights of the parties all wrapped up in a confirmation order that is enforced by a federal judge, is not subject to collateral attack, and is binding on all state and federal courts once it is final and non-appealable—generally 10 days after entry.

• You get to use some of those bankruptcy powers that simply aren’t available anywhere else.

The confirmation of a plan may be viewed as the last step in the fix, or alternatively as a description of what the fix is and how it will be implemented. A confirmed plan becomes the “law of the case”—a substitute contract that replaces the old creditor claims and equity interests.

Some debtors, as we discussed in a prior column, do not use chapter 11 to reorganize, but as a forum for an orderly liquidation. But even in those cases, the plan is the “fix” that dictates the parties’ rights—who will sell the assets, how they will be sold, over what time period and who will receive the proceeds. It is worthwhile to note that, with increasing frequency, the “fix” that is seized upon by debtors is a sale of all or substantially all estate assets under Bankruptcy Code §363 rather than a reorganization plan—a phenomenon that may make some bankruptcy judges feel like auctioneers—but the prototype is still a chapter 11 plan, and so we discuss that here and leave §363 sales for discussion in chapter 16.

It is impossible to generalize what activities and events will occur in any particular chapter 11 case because each case is so different. However, the typical chapter 11 case does involve certain interrelated groups of activities or processes. These include claims administration, avoidance and confirmation. We offer some thoughts on each below.

There is no rule that prescribes the order in which such tasks must be completed. Rather, when, or even if, these activities will take place in any given case will depend on a multitude of factors, including whether the case involves a “free fall,” “pre-arranged” or “pre-packaged bankruptcy;” whether the case involves a reorganization, liquidation or a sale of all assets to a third party; and the level of creditor cooperation. It will also depend on what issues are of most pressing concern in the particular case.

The manner in which one of these tasks is performed may impact the others. For instance, the claims-administration process is sometimes a critical part of the plan-confirmation process. As we touch upon later, a plan cannot be confirmed unless the bankruptcy court makes a number of specific findings. One such finding is that the debtor will be able to pay most §503 and §507 “administrative” and “priority” claims—those claims that Congress has determined should enjoy priority over other unsecured claims—on the “effective date” of the plan. Thus, thinking ahead to confirmation, debtors sometimes spend great resources on claims administration, addressing not only the validity and amount of claims, but also their priority levels. Successful chapter 11
debtors, however, often (perhaps even typically) defer claims administration and litigation to the post-confirmation period.

**Claims Administration**

If you are going to pay claims, you have to make sure you know whom to pay. If you are going to solicit votes on a plan, you have to know who gets to vote. If you are going to put claims into different classes, you have to know who goes in which class. So the problem of claims administration requires attention in even the simplest chapter 11 case.

The debtor gets the ball rolling by filing schedules of all its debts. If you are a creditor and the chapter 11 debtor has scheduled your claim correctly, that is enough to put you on the list. If not, you can file a claim (but for what it is worth, your authors would ordinarily file a claim in any event, just to be sure) prior to the applicable deadline (or “bar date”).

After there is a complete list of “possible” claims, as a result of the schedules and the proofs of claim, the debtor and other parties have the chance to assert objections. Sometimes these are asserted on a claim-by-claim basis; other times the objections will fall into broad categories and you will see “omnibus objections”—a single pleading objecting, for a similar reason, to dozens or even hundreds of claims. Here are some common objections:

- The claim is invalid under nonbankruptcy law. For the most part, you don’t have a claim in bankruptcy unless you would have a claim against the debtor outside bankruptcy, so this objection can be a knockout punch.
- The claim is valid but overstated (the debtor’s books and records reflect a lower amount due).
- The creditor is holding money or property of the debtor that he must return before his claim is allowed. (See §502(d)).
- The claim was filed too late. Claims filed after the bar date may be disallowed (in chapter 11) or subordinated (in chapter 7).
- The creditor asserts the wrong priority. High-priority claims get paid before low-priority claims. As a general matter, knocking the creditor down the priority ladder reduces his chance of getting paid.
- The claim is an unsecured claim for post-petition interest or professional fees, which are ordinarily not permitted.

Aside from allowing claims for payment, there is the matter of establishing claims for purposes of voting on the plan. To understand this point, you have to know a bit about the voting rules. When read together, §§1126 and 1129 provide that any creditor who is “impaired” by a plan gets a chance to vote on the plan. “Impairment,” generally speaking, means that one’s rights are changed or affected by the plan. Creditors vote by classes. To confirm a plan, you have to get
the approval of a majority in number and two thirds in amount of claims in each voting class. So, just as for payment, it matters for purposes of voting whether the creditor has an “allowed” claim, how big it is, and what class the claim is in. Claims are sometimes allowed in an estimated amount for voting purposes only, while ultimate resolution of the claim is deferred.

As to classification: Section 1123 provides that the plan may “designate...classes of claims.” Section 1122 says you may put a claim in a particular class only if the claim is ‘substantially similar’ to other claims in the same class. But you may be able to take claims that appear similar for nonbankruptcy law purposes and put them in different classes for purposes of the bankruptcy plan. This happens often enough that some of the worst fights in chapter 11 involve plan classification, with the dissenters arguing that the plan proponent is “gerrymandering” the classes while the proponent argues that there is a principled basis for its classification scheme.

Avoidance

By avoiding a particular transfer of property, the trustee or DIP can cancel a pre-petition (or, occasionally, an unauthorized post-petition) transaction and force the return or “disgorgement” of the payments or property, which then are available to pay all creditors pursuant to the priority rules set forth in the Bankruptcy Code. These powers are used to prevent unfair pre-petition payments to one creditor at the expense of all other creditors. Below are the common avoidance powers in chapter 11.

Fraudulent Transfers: A pre-petition transfer may be avoidable as either “intentional fraud” or “constructive fraud.” The former is a transfer made with actual intent to hinder, delay or defraud creditors. Think of the debtor-to-be who is being hounded by creditors, and so conveys his house and his bank account to his mother so that the creditors won’t seize them. The latter is a transfer made for less than reasonably equivalent value, while the debtor is insolvent (or which renders the debtor insolvent or leaves it with unreasonably small capital). This category could include, for example, the sale of a $10 million factory for $3 million, or the payment of a dividend to shareholders by an insolvent corporation, even if there was no intent to harm creditors.

The Bankruptcy Code includes its own fraudulent transfer power, set forth in §548 which covers transfers in the two year period prior to the petition date. But a trustee (or DIP) may also use state fraudulent conveyance laws, which tend to be generally similar to the federal statute, but with significantly longer reach-back periods.

Fraudulent transfers are discussed in more detail in Chapter 8.

Strong-arm Powers: Now, take, for example, a different case. Before bankruptcy, the debtor borrowed $1 million from BigBank and, to secure the loan, granted BigBank a security interest in its equipment. Typically, if BigBank wants to beat out competing third-party contenders, it will have to “perfect” this security interest—probably by filing a “financing statement” in the proper public records. If he fails to perfect, he will lose out to a competing creditor who gets a lien or share ratably with unsecured creditors.
Recall that the trustee is a kind of agent of creditors. So it is not surprising to learn that the trustee enjoys the rights of a lien creditor as of the petition date. In our case, this means that if the security interest is unperfected at the time of the bankruptcy filing, the trustee gets to set it aside. See §544(a)(1).

Preferences: Now, still another case. The debtor owes $10 each to the butcher, the baker and the candlestick maker. The debtor has assets worth only $10. He transfers all his assets to the butcher in satisfaction of the butcher debt, leaving the baker and the candlestick maker unpaid. What is the result? Observe that under the two rules we described above, it is probably bulletproof. There’s nothing to indicate it could be set aside by a lien creditor. It (probably) wasn’t done to defraud other creditors, and the debtor did get fair value for the payment (satisfaction of the $10 debt). Quite the contrary: Whatever the debtor did here, at least he paid a debt.

PREFERING ONE CREDITOR OVER ANOTHER USUALLY IS NOT WRONG OUTSIDE BANKRUPTCY. BUT BANKRUPTCY IS ALL ABOUT DISTRIBUTING ASSETS AMONG CREDITORS “AS THEIR INTERESTS MAY APPEAR.” IF YOU LET THE DEBTOR PICK AND CHOOSE WHOM HE PAYS, YOU MAY UPSET THE PURPOSE OF BANKRUPTCY. THUS, BANKRUPTCY LAW ALLOWS A DIP TO AVOID CERTAIN PRE-PETITION DEBT REPAYMENTS EVEN THOUGH THEY WOULD NOT BE AVOIDABLE OUTSIDE OF BANKRUPTCY. SEE §547. TYPICAL EXAMPLES OF PREFERENTIAL TRANSFERS INCLUDE THE LATE PAYMENT OF A TRADE DEBT (OUTSIDE THE “ORDINARY COURSE OF BUSINESS”), THE GRANTING OF A SECURITY INTEREST TO A PREVIOUSLY UNSECURED OR UNDER-SECURED LENDER, OR DELAYED PERFECION OF A SECURITY INTEREST GRANTED BY THE DEBTOR AT THE TIME IT INCURRED AN EARLIER DEBT. THE REACH-BACK PERIOD FOR PREFERENCES IS 90 DAYS BEFORE BANKRUPTCY, ALTHOUGH IT EXTENDS TO ONE YEAR IF THE RECIPIENT OR OTHER PARTY WHO BENEFITED FROM THE TRANSFER IS AN “INSIDER” OF THE DEBTOR (FOR DEFINITION OF “INSIDER,” SEE §101(31)).

VATS OF INK HAVE BEEN SPILLED OVER THE TRUSTEE AVOIDING POWERS, AND WE DON’T DO ANY MORE THAN HINT AT THE DIFFICULTIES HERE. MORE DISCUSSION OF THE TOPIC MUST AWAi Chapters 6 TO 8. WE RAISE THE TOPIC HERE MOSTLY FOR ONE REASON: THE WAY YOU MANAGE THE AVOIDING POWERS MAY DRIVE THE CHAPTER 11 CASE. IN SOME CASES, THE AVOIDING POWERS PROVIDE THE MOTIVE FOR FILING—EITHER TO RECOVER THE TRANSFER OR TO USE THE THREAT OF DOING SO TO REACH A DEAL. ON THE OTHER HAND, THERE MAY BE CASES WHERE THE DEBTOR AND PARTIES IN INTEREST WILL FINESSE THE AVOIDANCE PROBLEMS IN ORDER TO MAKE A DEAL THAT WOULDN’T HAPPEN OTHERWISE.

Confirmation

Here is the basic chronology in confirming a plan:

- Negotiate a plan with creditors (or their agents).
- Draft a plan and its disclosure statement.
- Get court approval for the disclosure statement.
- Only after getting that approval, solicit votes from holders of impaired claims.
• Count the votes.
• Ask the court to confirm your plan.

Plan Formulation. Key to the timely confirmation of a plan is a well-defined exit strategy, preferably one known on or before the petition date. The plan proponent must determine what exactly it wants from the reorganization, and how, from a business perspective, it plans to achieve it. Most often, the chapter 11 plan is proposed by the debtor. And during the “exclusive period” (the first 120 days of the case, or longer if the court grants an extension—which it often does—but subject to a maximum of 18 months), the debtor has the sole right to propose a plan. But after the exclusive period expires, other parties may propose a plan. If you play this game long enough, you will see some plans proposed by creditors’ committees, secured lenders and other parties. That is why we refer later on to the “plan proponent” rather than the “debtor.”

Plans may, and frequently do, provide for comprehensive changes in the financial and business structure of the debtor. Such changes may include sales of assets, cancellation or refinancing of debt (or conversion of debt to equity), curing or waiving of defaults, satisfaction or modification of liens, amendment of the debtor’s corporate charter, or changes in the amount, interest rate or maturity of outstanding debt.

A plan can provide that a creditor’s claim will be reduced, or paid back over a greater period of time or at a different interest rate than was contained in the original instrument. Bankruptcy courts have confirmed plans with repayment periods of up to 20 years or longer. A plan can also cancel existing issues of stock, replace existing issues with new issues or swap equity for debt and vice versa.

Investors and would-be acquirers can use chapter 11 as a means for accumulating control of a debtor-corporation and for influencing the corporate governance of a debtor, taking actions that often would be more difficult outside the realm of bankruptcy. For example, articles of incorporation can be amended in a plan to change the voting rights of different issues of shares or modify anti-takeover measures.

The Disclosure Statement. No one may solicit acceptance of a plan until the court approves a “disclosure statement” sufficient so a voter can “make an informed judgment about the plan.” See §1125(a)(1). The disclosure statement thus serves a function similar to a prospectus for an offering under securities law. (In addition, compliance with the disclosure statement requirements creates a limited safe harbor from certain securities laws requirements that would otherwise be applicable. See §1145).

Since no one can solicit consents without a court-approved disclosure statement, the hearing on disclosure typically becomes the first point of contact between the plan and the court. There are sometimes fights about the adequacy of the debtor’s disclosure statement. Most of the time, these really have more to do with confirmation than disclosure issues. Objectors often see the disclosure statement hearing as a first chance to raise concerns about the plan. In response, judges often tell such objectors to “save it for the confirmation hearing.”
One potential reaction to an objection seeking inclusion of additional information is for the debtor to request that the objecting party provide the specific language that they desire be inserted; there is a belief in some quarters that nobody reads the disclosure statement for disclosure: lawyers read the plan, which is controlling, and creditors read only the section of the disclosure statement that tells them what they will get and when they will get it. In fact, if the plan or disclosure statement contains an executive summary at the beginning, few creditors or interest holders may read further than that.

**Solicitation.** After the approval of the disclosure statement, the proponent solicits votes. Voting is done on a class-by-class basis. In order for a class to be deemed to have accepted a plan, the plan must be accepted by a majority in number of creditors who vote and at least two-thirds in debt amount of voting creditor claims in that class. For these purposes, the claims of insider creditors don’t count. Nor do those that have been objected to unless they have arranged for the court to temporarily allow them for purposes of voting.

If every impaired class of creditors votes to accept the plan, the proponent then asks the court to confirm the plan. If no impaired class votes to accept the plan, then the plan is dead on arrival and the proponent must come up with something else, or head back to the bargaining table. If some impaired classes vote to accept and others vote to reject, then the proponent may seek to “cram down” the dissenting classes (see more about that below).

**Basic tests for confirmation.** Upon receipt of the necessary acceptances, the plan proponent will request the bankruptcy court to confirm the plan at the confirmation hearing.

The Bankruptcy Code requires the bankruptcy court to make a number of specific findings to “confirm” (approve) a plan and make it binding on all parties. These findings are found in §1129. They include determinations that the plan complies with all applicable law and has been proposed in good faith. See §1129(a)(1)-(3). The bankruptcy court must also determine that the plan is feasible (i.e., that the debtor has a credible business plan and can reasonably be expected to perform its obligations and accomplish the objectives set forth in the plan). See §1129(a)(11).

If any individual creditor votes against the plan, then the plan must also pass the “best interests of creditors” test. See §1129(a)(7). This test requires the court to determine that the dissenting creditors or shareholders are receiving under the plan at least as much (in present value terms) as they would receive if the debtor were instead liquidated under chapter 7. It requires the court to compare (1) the probable distribution to the dissenting creditors or equity-holders if the debtor were liquidated with (2) the present value of the payments or property to be received or retained by the same creditors or equity-holders under the plan.

Stated more simply, if a class votes in favor of the plan, the plan will be binding on dissenters in that class as long as dissenting class members are getting at least as much as they would get in liquidation.

If a class of creditors votes to reject the plan, it may nevertheless be imposed on the class (“crammed down”) if (1) at least one impaired class has voted to accept the plan, §1129(a)(10),
and (2) the court finds that the treatment provided for objecting classes under the plan does not “discriminate unfairly” and is “fair and equitable” (the “fair and equitable” test), §1129(b).

The prohibition against “unfair discrimination” means that, ordinarily, similar claims or equity interests must be treated in like manner. There are examples of “fair” discrimination, however. For example, the enforcement of a contractual subordination provision to subordinate the claims of one class to the claims of another class does not discriminate “unfairly” against the subordinated class.

The precise determinations required for meeting the fair-and-equitable test turn on whether the class is secured or unsecured. Cramdown of a secured class will be permitted if the plan provides (1) that the objecting secured creditor class will retain a lien to the extent of its secured claim and will receive deferred cash payments that have a present value equal to at least the value of the creditor’s interest in the collateral, (2) for the sale of the secured creditor’s collateral with the creditor’s lien attaching to the proceeds or (3) for the realization by the secured class of the “indubitable equivalent” of its secured claim. (Nobody seems to know exactly what “indubitable equivalent” means, but one thing it may mean is turning over the secured creditor’s collateral to it in satisfaction of the secured claim.)

The permutations of possibilities under the different cramdown options can become quite complex, but as a general rule they boil down to the secured creditor receiving at least the value of its collateral.

The fair-and-equitable test for unsecured claimants and shareholders is much simpler. Generally speaking, a class of unsecured claims can be crammed down if the plan provides either that the creditors in the class receive (over time) cash payments equal to the present value of their unsecured claims (i.e., payment in full) or that junior classes (such as subordinated creditors or stockholders) receive nothing under the plan. Equity security-holders may be crammed down along similar lines. Cramdown cases are far more often threatened than confirmed, but the cramdown power provides important bargaining leverage.

Post-confirmation

Confirmation represents a significant achievement in a chapter 11 case, and it is generally viewed as the end goal of a chapter 11 filing. By entering a confirmation order, the court blesses the deal reflected in the plan and makes it enforceable; stated plainly, confirmation represents consummation of the business “deal” between the relevant parties. Confirmation, like chapter 11 itself, should not be the goal in and of itself. Rather, chapter 11 is a venue for getting to a deal and confirmation is akin to the signing of the contract that memorializes the deal.

However, confirmation does not end the case. A number of important aspects often remain to be completed after confirmation. This may include consummating transactions provided for in the plan, resolving claims, and litigating adversary proceedings. The case will be “over” when a final decree is entered by the bankruptcy court clerk, closing the case.
chapter 3
what every secured creditor (and its lawyer) should know about chapter 11

who is a secured creditor? it is a creditor who holds a security interest in specific property of the debtor. a secured creditor may be the holder of a real estate mortgage, a bank with a lien on all assets, a receivables lender, an equipment lender, the holder of a statutory lien or any number of other types of entities. it may be a senior lender or a subordinate lender. it may be oversecured, fully secured or undersecured. it may have a long-term business relationship with the debtor and/or its principals, or the loan may be a one-shot deal. the loan may be a big loan for the lender or a minor matter. so, there is no such thing as “the secured-lender perspective.” even among secured lenders, where you stand is a function of where you sit, and one secured lender may sit in a very different place than another.

but some concerns are common to most, if not all, secured lenders, and these are addressed below.

Can the Debtor Use a Secured Creditor’s Collateral During the Case?

the short answer is “yes, probably” (but keep reading). the debtor is typically allowed to continue to use a secured lender’s collateral during the bankruptcy case. for example, if you have a mortgage lien on an office building or a security interest in a machine press, the debtor will be permitted to continue to use your collateral, even if the secured loan is in default. however, as discussed in the next section below, under some circumstances, the secured creditor may be entitled to compensation for loss of value caused by the use.

if a lender has a security interest in “cash collateral,” which includes both cash and cash equivalents, including the cash proceeds of hard collateral (e.g., cash in a bank account, the proceeds of accounts receivable, rents from an office building or hotel, etc.), there are special rules. in order to use cash collateral, a debtor must have the secured creditor’s consent or a court order.

typically, a debtor will need immediate access to cash collateral when it files for bankruptcy, and will file an “emergency motion for authority to use cash collateral” as one of its “first-day motions.” in most cases, the secured creditor will use this opportunity to negotiate with the debtor to obtain certain rights or concessions in exchange for the creditor’s consent to the use of its cash collateral. in such cases, the judge may simply enter a stipulated order reflecting the parties’ bargain (assuming such bargain does not appear unreasonable to the judge).

in some instances, however, the parties are unable to reach an agreement, and a contested hearing will be held to determine the debtor’s right to use cash collateral. during a contested hearing, the secured creditor must establish that the cash at issue is, in fact, its cash collateral, such task is ordinarily not very difficult, but it requires the creditor to provide the court with competent evidence at the hearing. once the creditor has met its burden, the debtor must then
prove that it can provide “adequate protection” to the creditor in order to obtain permission to use the cash collateral.

What Is Adequate Protection?

Adequate protection, described in Bankruptcy Code §361, can take on many forms, including periodic cash payments to the secured lender, payment of post-petition interest or the granting of additional liens to the creditor on previously unencumbered assets. The form the protection will take depends on, among other things, how great the risk is to the secured lender, what the cash collateral is being used for, and what types of protection the debtor is able to offer.

For example, where the primary collateral is accounts receivable, it is common for the lender to be granted a “replacement lien” on receivables generated post-petition. Such protection is significant because §552 operates to cut off any receivables lien as of the bankruptcy filing date. Under this arrangement, the debtor spends the proceeds of the receivables that are subject to the lender’s original lien in exchange for a lien on new “replacement” receivables. If the debtor continues to generate new receivables at the same rate or higher as it spends the proceeds of old (pre-petition) receivables, then the lender would be adequately protected.

What if the debtor is using the proceeds of a lender’s “hard collateral” to preserve that hard collateral (e.g., rents generated by an apartment building are used to preserve and maintain the building)? Often such an arrangement is, without more, considered adequate protection because the maintenance and upkeep of the building benefits the lender as mortgagee.

In a similar fashion, if the secured lender has an “equity cushion”—the value of the “hard collateral” substantially exceeds the amount of the secured debt—that lender is likely to be deemed to have adequate protection. The theory for this outcome is that if the value of the secured creditor’s collateral substantially exceeds the debt owed to it, the use of cash collateral is unlikely to present an unfair risk to the secured lender.

One natural idea for adequate protection would be to give the secured creditor an administrative priority claim to the extent of any diminution in its collateral value, but §361(3) provides that this is not adequate protection. However, in the event a secured lender’s adequate protection proved to be insufficient to compensate it for a loss of collateral value during the case, the lender may be entitled to a “super-priority” administrative claim under §507(b), which gives the lender priority over other “regular” administrative claims, and acts as a backstop provision to protect the secured lender.

What Happens if the Lender’s Collateral Decreases in Value During the Case?

There are several reasons why the value of a secured creditor’s collateral might diminish during the course of a bankruptcy case. One reason is the debtor’s use of that collateral. For example, if your collateral is a new car, and the debtor drives the car for a year and puts 15,000 miles on it during the case, the value will be diminished. Another reason for diminution may be
market value. For example, this is common where the collateral is comprised of securities, or other assets whose value fluctuates over time.

This risk is of particular concern to a secured creditor because, as discussed below, the secured creditor is generally precluded from foreclosing on its collateral during the case. So must a creditor just sit idly by and watch its collateral value erode? Not quite. The Bankruptcy Code recognizes that a secured creditor may be entitled to protection against a decline in collateral value over the course of a bankruptcy case.

The concept of adequate protection, described above as it relates to the debtor’s ability to use cash collateral, also applies in the event that the value of non-cash collateral should decline. Bankruptcy Code §363(e) provides that, on request of a secured creditor, the court is to condition the debtor’s right to use (or sell or lease) collateral upon provision of adequate protection to the secured creditor. Similarly, §362(d)(1) provides that the court may grant relief from the automatic stay to a secured creditor (allowing it to exercise remedies against its collateral) if the debtor is unable (or unwilling) to provide adequate protection.

As noted above, the court has broad discretion in fashioning the form of adequate protection. However, the court will not take the initiative to monitor a lender’s collateral value to ensure the presence of adequate protection, nor should a secured lender rely on the debtor to offer adequate protection. Accordingly, if a secured creditor believes that its collateral value is declining post-petition, it is incumbent on the creditor to file a motion for adequate protection (or for relief from the automatic stay) in order to trigger consideration of the issue by the court.

A few more points are worth making on this issue. First, the mere fact that the automatic stay operates to delay a secured creditor’s ability to exercise its remedies against the debtor or its collateral is not sufficient to justify an award of adequate protection. You do not get compensated for delay caused by the automatic stay, even if you can show that it is imposing a real inconvenience upon you. The automatic stay causes inconvenience for nearly all creditors. This is not enough. Instead, you must affirmatively prove that you are suffering post-petition decline in collateral value.

Second, a creditor who is significantly oversecured (i.e., collateral value exceeds debt amount) is unlikely to get adequate protection, even if its collateral value is declining. Courts sometimes refer to a decline in the margin between collateral value and debt amount as “erosion of the equity cushion” and frequently will not award adequate protection in these situations. However, as the collateral value gets closer to the debt amount, the prospects for adequate protection improve; you don’t have to wait until you are undersecured to ask for (or receive) adequate protection.

Finally, it should be noted that collateral value is not always obvious. If your collateral consists of shares of a public company or a foreign currency account, you’ll be able to figure out its value pretty easily on any given day. And if it’s a car, you can come close enough by looking in the Kelly Blue Book. But if your collateral is a farm, an apartment project or a hospital, you will probably need expert testimony to establish collateral value, and the quality of your expert
analysis and testimony will be critically important to gaining the relief you are seeking. Thus, the quest for adequate protection often becomes a battle of valuation experts.

**How Can a Secured Creditor Foreclose on Its Collateral During the Case?**

As noted above, pursuant to §362 of the Bankruptcy Code, the automatic stay generally prohibits any action by a secured creditor to recover or foreclose on its collateral during a bankruptcy case. The next chapter explores the contours of the automatic stay in more detail, but for now, we suggest you look through §362(b) to see whether the action your client wants to take is excepted from the stay; there are some narrow exceptions for particular situations.

But if you’re just a regular secured creditor who wants to foreclose, you’re unlikely to find an applicable exception. After all, one of the main purposes behind chapter 11 is to give the debtor breathing room to formulate a plan so it can try to preserve going-concern value. If secured creditors could generally foreclose on their collateral, there wouldn’t be much breathing room and there probably wouldn’t be much chance for a company to emerge from bankruptcy as a going concern. So even if your loan is in default, you’re pretty much stuck.

Well, almost. Bankruptcy Code §362(d) provides a few avenues for relief from the automatic stay. To obtain this relief, you must file a “motion for relief from the automatic stay,” which is a contested matter pursuant to Bankruptcy Rule 9014 (not an adversary proceeding under Rule 7001). Bankruptcy Code §362(e) provides for prompt consideration by the court of stay relief motions. Many such motions are resolved within 30 days after they are filed, although, as you will see, if you read §362(e) carefully, that does not always have to be the case.

The first ground for relief from the stay is “cause, including lack of adequate protection.” So if the court finds that the creditor is entitled to adequate protection, but the debtor can’t (or won’t) provide it, then the creditor is entitled to stay relief. This provision suggests that lack of adequate protection is not the only “cause” justifying relief from the stay, but fails to enumerate any additional basis for demonstrating “cause.” This ambiguity obviously gives the judge a lot of discretion. We can’t possibly list all the things that might be found to constitute “cause,” since they are by nature specific to any individual case. As a general matter, we think courts tend to balance the harm imposed on the secured creditor by continuing the stay, against the benefit of the stay to the debtor, with a significant presumption in favor of the debtor.

The second ground for relief from the stay is satisfied if (1) there is no equity in the property and (2) the property is “not necessary to an effective reorganization.” The first prong (no equity) means that the debt secured by liens on the property exceeds the value of the property. The second prong (not necessary) means either that the debtor can reorganize without this particular piece of property or that the debtor is unlikely to be able to reorganize at all (if the debtor cannot reorganize at all, then no property is “necessary” for its reorganization). The secured creditor has the burden of proof on the “no equity in the property” issue, but the debtor has the burden of proof on the “necessary for an effective reorganization” issue.
The third ground for relief from the stay applies only to single-asset real estate cases. If you’re involved in such a case, have a look at §362(d)(3) and the definition of single asset real estate in §101(51)(B).

The final stay relief provision applies to real estate whose ownership has been transferred or which has been subject to another bankruptcy case as a part of a fraudulent scheme. It allows for so-called in rem stay relief to be recorded in the public records to provide up to two years worth of relief from stay for acts against the property in a future bankruptcy case.

*Will a Secured Creditor Continue to Get Interest (and/or Other Payments) During the Case?*

Secured creditors (even those who are oversecured) ordinarily do not receive principal payments during the case—even if they are due under the terms of the loan. This includes loans that mature during the case. However, if a creditor is oversecured (where the collateral value after deducting any senior liens exceeds the debt), the secured creditor will be entitled under §506(b) to at least the accrual of post-petition interest (and reasonable attorneys’ and other professional fees, if provided for in the loan documents) to the extent it is oversecured. If a secured creditor is undersecured (the collateral value is less than the debt), post-petition interest is ordinarily not awarded.

But even for the oversecured creditors, there are a couple of caveats. First, note that we said you get post-petition interest (and fees) "to the extent" you’re oversecured. In other words, if the collateral value is $1 million and the debt amount is $950,000, then the secured creditor should only receive post-petition interest (and fees) up to a total of $50,000. Second, even if the court finds that the creditor has a right to interest, it doesn’t follow that the creditor will get the cash right away. Instead, the interest will accrue to the creditor’s claim (although in some circumstances, the creditor may be able to negotiate for current interest payments in exchange for consent to use of cash collateral). Third, a secured creditor may or may not receive interest at the default rate, even if the loan is in default, depending in large part on how high the default rate is relative to the contract rate. Finally, keep in mind that collateral values often vary throughout the case, and just because you are oversecured at the beginning of the case does not mean you will be oversecured throughout.

*Is There Any Chance Someone Will Take the Position that a Secured Loan Isn’t Really a Loan, or Should Be Subordinated, and How Likely Is That to Happen?*

Two bad words in the lender community are “recharacterization” and “equitable subordination.” These doctrines are more often talked about than actually applied, but they are worth mentioning here because (1) this is an area where a little forethought can go a long way, and (2) in the relatively rare circumstances that these doctrines are applied, the consequences can be disastrous for the lender.
There is a principle in bankruptcy law called “recharacterization,” by which a bankruptcy court may characterize a transaction in accordance with its economic substance rather than its form. One example of this is the recharacterization of debt as equity. Factors that courts look to in determining whether to recharacterize debt as equity include whether (1) the “lender” was also a stockholder, (2) the “lender” obtained control of the borrower in exchange for the “loan,” (3) the corporation could obtain outside funding, (4) the “lender” received additional equity in exchange for the investment, (5) there was a fixed maturity date for the “loan,” (6) the debtor had adequate capital at the time of the “loan,” and (7) the transaction was documented as a loan. If the transaction is an arms-length one, i.e., the lender is not a shareholder or affiliated entity, then recharacterization is a remote risk, if it is a risk at all. But when dealing with insider loan situations, it is particularly worth thinking about.

Another doomsday scenario for the secured lender is “equitable subordination.” Section 510(c) of the Bankruptcy Code allows the court to subordinate any claim to any other claim(s), and/or to transfer a secured lender’s lien to the estate (where it will benefit all creditors rather than just the secured creditor). The risk of equitable subordination is highest when the lender is held to have acted inequitably, to the detriment of other creditors. A common fact pattern involves a lender who exercised an unreasonable level of control over the debtor and its business. Sometimes there is a fine line, as a secured lender, between trying to assure that the debtor operates in a way that maximizes the prospects for repayment and the sort of “undue control” that can lead to equitable subordination.

**Can the Debtor Sell a Secured Creditor’s Collateral During the Case, and If So, What Does That Secured Creditor Get?**

A debtor may sell assets in the ordinary course of business without court approval. For example, a retail debtor may sell inventory to its retail customers without the need for court approval. If the sale is outside the ordinary-course-of-business, however, court approval is necessary.

As a baseline rule, the sale of encumbered assets will result in the lien following the asset; if a debtor sells an office building that is encumbered by a mortgage, the mortgage would continue to encumber the building. Debtors, however, often want to sell assets “free and clear” of liens. This is possible, under §363(f), if one of the five criteria set forth in that section are satisfied. The most common of these criteria are that the secured creditor consents, or where the sale price is greater than the amount of debt encumbering the asset to be sold. In these situations, a lien will attach to the proceeds of the sale (which are often promptly used in turn to pay off the lien).

Finally, if a secured creditor’s collateral is sold, the creditor has the right to “credit bid” (i.e., off set his claim against his bid, rather than paying out cash) at the sale, pursuant to §363(k) of the Bankruptcy Code.
What Happens if the Chapter 11 Case Gets Converted to Chapter 7?

The primary goal of a chapter 7 trustee is to distribute assets to unsecured creditors (although this goal is rarely achieved because in the overwhelming majority of chapter 7 cases, there’s nothing to distribute). Thus, if a secured creditor’s collateral is worth more than the liens encumbering it plus the costs of a sale, a chapter 7 trustee is likely to sell the collateral, pay the costs of sale and the liens, take his commission (subject to court approval) and distribute the remainder to other creditors. If the collateral is worth less than the liens encumbering it (plus the costs of a sale), then the trustee is likely to abandon the collateral (or consent to relief from the stay so that a lienholder can foreclose). The bottom line is that, in chapter 7, a secured creditor is likely to get either repayment of its debt or title to its collateral. Often, a secured creditor’s collateral is worth much more if it can be liquidated on a “going-concern” basis rather than in a “fire sale.” Usually, going-concern sales can be achieved only in chapter 11 cases, but even in chapter 7, the bankruptcy court may (and occasionally does) authorize the business to be operated in order to achieve going-concern value.

What Is the Impact of Post-petition Financing on the Secured Creditor?

Many debtors will need new post-petition financing in order to be able to operate during bankruptcy. Bankruptcy Code §364 provides a series of inducements to the post-petition lender, who otherwise might not be inclined to lend money to a bankrupt company. Chapter 11 of this book is devoted to the issue of post-petition financing (also referred to as “DIP lending”). For now, we mention only a few issues that are of particular relevance to the pre-petition secured creditor.

DIP lenders often insist on a lien on estate assets in order to make a DIP loan. Courts typically will approve this if the debtor can show that post-petition financing on an unsecured basis is not available.

If there are unencumbered assets, the debtor may pledge these to the DIP lender to secure the post-petition loan. This will typically not be of particular concern to the pre-petition secured creditor. But often there are not unencumbered assets, or at least not sufficient unencumbered assets to make the DIP lender comfortable. In these situations, the court may grant to the DIP lender a lien on already encumbered assets—a pre-petition lender’s collateral. This lien may be subordinate to existing liens on such collateral, on an equal priority with existing liens (sometimes called “pari passu” with existing liens), or even senior in priority to existing liens (a so-called “priming lien”).

In order to grant a pari passu lien or a priming lien, the debtor must provide adequate protection to the existing secured creditor. It is particularly difficult to get permission to do a priming lien over the objection of a pre-petition secured creditor, since doing so typically imposes significant risk on the pre-petition lender. The case law imposes a heavy burden on a debtor who seeks to grant a priming lien over the objection of an existing secured lender. But it is done in some cases, such as where the existing secured lender is substantially oversecured.
A pre-petition secured lender may sometimes consent to the *pari passu* or priming lien. For example, such a lender may realize that the debtor needs new financing in order to be able to continue to operate (and preserve the value of its collateral), but may not want to put in new money itself. So, it may agree to subordinate its pre-petition lien in favor of a new lender. In our experience, most priming liens are done on a consensual basis.

Sometimes the pre-petition secured lender will also be the DIP lender. The existing lender is a natural candidate, since it knows the debtor and has an incentive to protect its pre-petition investment. In that case, the lender may “prime” its pre-petition loan with a new post-petition loan. Not surprisingly, this is less controversial than a new lender obtaining a priming loan.

*How Will a Secured Creditor Be Treated in the Event that the Debtor Confirms a Reorganization Plan?*

In most cases where a plan is confirmed, the secured creditor, debtor and possibly unsecured creditors make a deal of some sort, and that deal is reflected in the terms of the plan. The deal may take many different forms—a sale of collateral, conveyance of collateral to the secured creditor, restructuring the loan, partial pay-down, third-party lender refinance, granting additional collateral, giving equity to the creditor, changing the loan terms, etc. The possibilities are (almost) endless.

In those cases where no deal is made, the debtor may resort to the “cramdown” provisions of the Bankruptcy Code. These provisions allow a debtor that has the support of at least one impaired class of creditors (*i.e.*, a class of creditors whose rights are modified by the plan) to modify the terms of a secured obligation—even over the objection of the secured creditor. The debtor who wants to “cram down” a secured creditor has three basic options, which are described in §1129(b)(2)(A).

First, the debtor can give the secured creditor a note secured by its existing collateral, with a principal amount equal to the value of the collateral, and a market interest rate. For example, if the creditor is owed $1.8 million but has collateral with a value of $1.3 million, the debtor must give the creditor a $1.3 million note with a term that is adjudged to be fair by the bankruptcy court, as well as a “market” interest rate. This rate will depend, among other things, on the length of the term involved. Generally, the longer the term, the higher the risk, and therefore, the higher the interest rate.

A creditor may choose to make the “fully-secured” election under §1111(b), which triggers the application of an additional requirement. In this event, not only will the debtor have to give a note with a principal amount equal to the collateral value and a market interest rate, but the face value of total payments of principal and interest over the life of the plan must at least equal the total amount of the secured creditor’s debt. This election is not often made, but when representing an undersecured creditor, you ought to at least consider it.

The second option is that the debtor can sell the creditor’s collateral, giving the creditor a lien on the sale proceeds. The debtor can then either pay off the loan using the sale proceeds or
give the creditor a note secured by the cash proceeds. The creditor has a credit bid right in any such sale.

The third option is referred to as “indubitable equivalent.” This is one of the most cryptic phrases in the Bankruptcy Code, and nobody really knows what it means. Most often it is invoked when a debtor wants to convey a secured creditor’s collateral to the secured creditor in satisfaction of the secured debt. (In real estate cases, this is sometimes referred to as “dirt for debt”). Sometimes, when the creditor is oversecured, the debtor will seek to convey to the secured creditor only a part of the collateral to extinguish the debt, arguing that only part of the collateral is necessary to satisfy the whole debt. This might occasionally work, but the debtor should be prepared to make a very clear and very compelling case that the secured creditor is being made whole.
APPENDIX 3(a)
IN RE SUBMICRON SYSTEMS CORPORATION

This edited order explores the contours of a secured creditor’s credit bid right—A market based method of protecting it from undervaluation of its collateral—and “recharacterization” and equitable subordination.

432 F.3d 448 (3rd Cir. 2006)

Appellant Howard S. Cohen (“Cohen”), as Plan Administrator for the bankruptcy estates of SubMicron Systems Corporation, SubMicron Systems, Inc., SubMicron Wet Process Stations, Inc. and SubMicron Systems Holdings I, Inc. (jointly and severally, “SubMicron”), challenges the sale to an entity created by Sunrise Capital Partners, LP (“Sunrise”) of SubMicron’s assets under 11 U.S.C. §363(b), which authorizes court-approved sales of assets “other than in the ordinary course of business.” Sunrise negotiated directly with several—but not all—of SubMicron’s creditors before presenting its bid to the District Court. These creditors—The KB Mezzanine Fund II, LP (“KB”), Equinox Investment Partners, LLC (“Equinox”), and Celerity Silicon, LLC (“Celerity”)—agreed to contribute toward the purchase of SubMicron’s assets new capital along with all of their claims in bankruptcy against SubMicron in exchange for equity in the entity formed by Sunrise to acquire the assets—Akrion LLC (“Akrion”). Akrion in turn “credit bid” the full value of the Lenders’ secured claims contributed to it as part of its bid for SubMicron’s assets pursuant to 11 U.S.C. §363(k). The District Court approved the sale. Cohen v. KB Mezzanine Fund II, L.P. (In re SubMicron Sys. Corp.), 291 B.R. 314 (D. Del. 2003).

Cohen, seeking as Plan Administrator of the SubMicron estates to aid unsecured creditors “cut out of the deal” by the Lenders and Sunrise, attacks the sale on several fronts. First, he argues that the purportedly secured debt investments made by the Lenders and contributed to Akrion should have been recharacterized by the District Court as equity investments. In the alternative, if the District Court did not err in declining to recharacterize the investments as

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1 Equinox was formed in 1996 to manage KB after it was acquired by Dresdner Bank. For the sake of simplicity, we shall refer to both entities simply as “KB/Equinox.”

2 This provision reads:

   At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.


3 This bankruptcy case is before the District Court because it withdrew, pursuant to 28 U.S.C. §157(d), the reference of the case to the Bankruptcy Court for the District of Delaware.
equity, Cohen contends that it erred by failing to conclude that the debt was unsecured. Even if the District Court properly considered the debt secured, Cohen challenges the propriety of the District Court’s allowance of the credit bid portion of Akrion’s offer. As a last option, Cohen asserts that the District Court erred by declining to equitably subordinate the Lenders’ secured claims to those of creditors with inferior claims. For the reasons discussed below, we reject these arguments and affirm the judgment of the District Court.

I. Facts and Procedural Posture

A. SubMicron’s Financing

Before its sale in bankruptcy, SubMicron designed, manufactured and marketed “wet benches” for use in the semiconductor industry. By 1997, it was experiencing significant financial and operational difficulties. To sustain its operations in the late 1990s, SubMicron secured financing from several financial and/or investment institutions. On Nov. 25, 1997, it entered into a $15 million working capital facility with Greyrock Business Credit (“Greyrock”), granting Greyrock first priority liens on all of its inventory, equipment, receivables and general intangibles. The next day, SubMicron raised another $20 million through the issuance of senior subordinated 12 percent notes (the “1997 Notes”) to KB/Equinox (for $16 million) and Celerity (for $4 million) secured by liens behind Greyrock on substantially all of SubMicron’s assets. Submicron subsequently issued a third set of notes in 1997 (the “Junior 1997 Notes”) for $13.7 million, comprising $8.7 million of 8 percent notes and a $5 million note to The BOC Group, Inc. The Junior 1997 Notes were secured but junior to the security for the 1997 Notes. Despite this capital influx, SubMicron incurred a net loss of $47.6 million for the 1997 fiscal year.

A steep downturn in the semiconductor industry made 1998 a similarly difficult year for SubMicron. By August of that year, it was paying substantially all of the interest due on the 1997 Notes as paid-in-kind senior subordinated notes. On Dec. 2, 1998, SubMicron and Greyrock agreed to renew the Greyrock line of credit, reducing the maximum funds available from $15 to $10 million and including a $2 million overadvance conditioned on SubMicron’s securing an additional $4 million in financing. To satisfy this condition, on Dec. 3, SubMicron issued Series B 12 percent notes (the “1998 Notes”) to KB/Equinox (for $3.2 million) and Celerity (for $800,000). The 1998 Notes ranked pari passu with the 1997 Notes and the interest was deferred until Oct. 1, 1999. SubMicron incurred a net loss of $21.9 million for the 1998 fiscal year, and at year’s end its liabilities exceeded its assets by $4.2 million.

SubMicron’s financial health did not improve in 1999. By March of that year, its management determined that additional financing would be required to meet the company’s immediate critical working capital needs. To this end, between March 10, 1999 and June 6, 1999, SubMicron issued a total of eighteen Series 1999 12 percent notes (the “1999 Tranche One

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4 Wet benches are automatic process tools used for cleaning and etching operations in semiconductor processing. See http://www.semiconductorglossary.com/default.asp?searchterm=wet+bench (last visited Dec. 27, 2005).
Notes”) for a total of $7,035,154 (comprising nine notes to KB/Equinox totaling $5,888,123 and nine notes to Celerity totaling $1,147,031). The 1999 Tranche One Notes proved insufficient to keep SubMicron afloat. As a result, between July 8, 1999 and August 31, 1999, KB/Equinox and Celerity made periodic payments to SubMicron (the “1999 Tranche Two Funding”) totaling $3,982,031 and $147,969, respectively. No notes were issued in exchange for the 1999 Tranche Two Funding. Between the 1999 Tranche One Notes and the 1999 Tranche Two Funding (collectively, the “1999 Fundings”), KB/Equinox and Celerity advanced SubMicron a total of $9,870,154 and $1,295,000, respectively. (The 1999 Fundings were recorded as secured debt on SubMicron’s 10-Q filing with the Securities and Exchange Commission.) Despite the cash infusions, during the first half of 1999 SubMicron incurred a net loss of $9.9 million. On June 30, 1999, SubMicron’s liabilities exceeded its assets by $3.1 million.

By January 1999, KB/Equinox had appointed three members to SubMicron’s Board of Directors. All appointees were either principals or employees of KB/Equinox. By June 1999, following resignations of various SubMicron Board members, KB/Equinox employees Bonaparte Liu and Robert Wickey, and Celerity employee Mark Benham, represented three-quarters of the Board, with SubMicron CEO David Ferran the lone Board member not employed by KB/Equinox or Celerity.

B. The Acquisition

SubMicron began acquisition discussions with Sunrise in July of 1999. By all accounts, it was generally understood that if SubMicron failed to reach a deal with Sunrise, it would be forced to liquidate, leaving secured creditors—with the exception of Greyrock—with pennies on the dollar and unsecured creditors and shareholders with nothing. KB/Equinox, not SubMicron’s management, conducted negotiations with Sunrise, developing and agreeing on the terms and financial structure of an acquisition to occur in the context of a prepackaged bankruptcy.

On August 31, 1999, SubMicron entered into an asset purchase agreement with Akrion, the entity created by Sunrise to function as the acquisition vehicle. The following day, SubMicron filed a Chapter 11 bankruptcy petition and an associated motion seeking approval of the sale of its assets to Sunrise outside the ordinary course of business pursuant to §363(b) of the Bankruptcy Code.

The asset purchase agreement reiterated, inter alia, that KB/Equinox and Celerity would contribute their secured claims (i.e., the 1997 Notes, the 1998 Notes and the 1999 Fundings) in order for Akrion to credit bid these claims under §363 of the Bankruptcy Code—but only contingent on the closing of the sale. The agreement also required SubMicron, at the closing of the sale, to pay $5,500,000 immediately to the holders of the 1999 Fundings. In return, KB/Equinox and Celerity would receive a 31.475 percent interest in Akrion (KB/Equinox received a 30 percent interest and Celerity received a 1.475 percent interest). The Court and Official Committee of Unsecured Creditors (the “Creditors’ Committee”) were apprised of the terms of this agreement prior to the sale.

At the sale hearing Akrion submitted a bid of $55,507,587 for SubMicron. The cash component of the bid totaled $10,202,000 and included $5,500,000 in cash from Akrion,
$3,382,000 to pay pre- and post-petition Greyrock secured debt, and $850,000 to cover administrative claims. The credit portion of the bid consisted of the $38,721,637 outstanding for the 1997 Notes, the 1998 Notes, and the 1999 Fundings (all of which KB/Equinox and Celerity had contributed to Akrion), plus $1,324,138 in individual secured claims, for a total of $40,045,775. Finally, the bid included SubMicron’s liabilities that would be assumed by Akrion—$681,346 in lease obligations and $4,578,466 in other assumed liabilities for a total of $5,259,812. No other bid for SubMicron’s assets was made, SubMicron’s Board and the Court both approved Akrion’s bid over the objection of the Creditors’ Committee, and on Oct. 15, 1999, the asset sale closed.

On April 18, 2000, the Creditors’ Committee brought against the Lenders, among others, an adversary proceeding in which it made the claims before us on appeal. (Cohen was subsequently substituted for the Creditors’ Committee.) After a bench trial before Judge Sue Robinson in late July/early August 2001, she ruled against Cohen, setting out her reasoning in a comprehensive opinion. Cohen appeals.

II. Jurisdiction and Standard of Review

Because the typical reference of bankruptcy cases to bankruptcy courts was withdrawn here by the District Court, our appellate jurisdiction stems from 28 U.S.C. §1291, not 28 U.S.C. §158(d). In re PWS Holding Corp., 228 F.3d 224, 235 (3d Cir. 2000); In re Marvel Entm’t Group, Inc., 140 F.3d 463, 470 (3d Cir. 1998). “We review the District Court’s legal determinations de novo, its factual findings for clear error, and its exercise of discretion for abuse thereof.” In re PWS Holding Corp., 228 F.3d at 235 (citing Manus Corp. v. NRG Energy, Inc. (In re O’Brien Envtl. Energy, Inc.), 188 F.3d 116, 122 (3d Cir. 1999)).

III. Recharacterization as Equity

Cohen argues that the District Court erred by failing to recharacterize the infusion of the 1999 Fundings as an equity investment. To succeed with this argument, he must demonstrate that the District Court abused its discretionary authority or premised its determination on clearly erroneous findings of fact. Because he has failed to do so, we affirm the District Court’s recharacterization holding.

A. Recharacterization / Equitable Subordination

At the outset, it is important to distinguish recharacterization from equitable subordination. Both remedies are grounded in bankruptcy courts’ equitable authority to ensure

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5 These enumerated components of the cash portion of the bid total $9,732,000, not $10,202,000. The District Court’s opinion leaves unclear what accounted for the missing $470,000.

6 Bankruptcy courts’ general powers of equity are codified at 11 U.S.C. §105(a), which states that a “court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].” The power of equitable subordination is specifically codified at 11 U.S.C. §510(c), which states that:

(Continued…)
“that substance will not give way to form, that technical considerations will not prevent substantial justice from being done.” Pepper v. Litton, 308 U.S. 295, 305, 60 S. Ct. 238, 84 L. Ed. 281 (1939). Yet recharacterization and equitable subordination address distinct concerns. Equitable subordination is apt when equity demands that the payment priority of claims of an otherwise legitimate creditor be changed to fall behind those of other claimants. See, e.g., Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims, 160 F.3d 982, 986-87 (3d Cir. 1998); Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.), 269 F.3d 726, 749 (6th Cir. 2001). In contrast, the focus of the recharacterization inquiry is whether “a debt actually exists.” In re Autostyle Plastics, 269 F.3d at 748 (internal quotation marks omitted) or, put another way, we ask what is the proper characterization in the first instance of an investment.7 For these reasons, we agree with those courts that have determined that “the issues of recharacterization of debt as equity capital and equitable subordination should be treated separately.” Blasbalg v. Tarro (In re Hyperion Enters., Inc.), 158 B.R. 555, 560 (D. R.I. 1993); see, e.g., In re Autostyle Plastics, 269 F.3d at 749 (explaining that “because both recharacterization and equitable subordination are supported by the Bankruptcy Code and serve different purposes, we join those courts that have concluded that a bankruptcy court has the power to recharacterize a claim from debt to equity” and collecting cases); Aquino v. Black (In re Atlantic Rancher, Inc.), 279 B.R. 411, 433 (Bankr. D. Mass. 2002) (stating that “while once considered solely in conjunction with the doctrine of equitable subordination, bankruptcy courts now consider recharacterization a separate cause of action”).

Cohen advances both arguments. He argues that the infusion of the 1999 Fundings is most accurately characterized as an equity investment—a recharacterization argument—and, in the alternative, that if the infusion is deemed a debt investment, the Lenders’ claims should be equitably subordinated. We turn first to the recharacterization argument, as “determining [an] equitable subordination issue prior to determining whether [an] advance is a loan or [an equity investment] is similar to taking the cart before the horse.” Diasonics, Inc. v. Ingalls, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990). If a “particular advance is a capital contribution,...then equitable subordination never comes into play.” In re Georgetown Bldg. Assocs., 240 B.R. at 137.

7 In this context, the label “recharacterization” is misleading. See Citicorp Real Estate, Inc. v. PWA, Inc. (In re Georgetown Bldg. Assocs. Ltd. P’ship), 240 B.R. 124, 137 (Bankr. D.D.C. 1999) (“The debt-versus-equity inquiry is not an exercise in recharacterizing a claim, but of characterizing the advance’s true character.” (emphasis in original)); In re Cold Harbor Assocs., L.P., 204 B.R. 904, 915 (Bankr. E.D. Va. 1997) (“Rather than recharacterizing the exchange from debt to equity, or subordinating the claim for some reason, the question before this Court is whether the transaction created a debt or equity relationship from the outset.”).
B. Recharacterization Framework

In defining the recharacterization inquiry, courts have adopted a variety of multi-factor tests borrowed from nonbankruptcy caselaw. While these tests undoubtedly include pertinent factors, they devolve to an overarching inquiry: the characterization as debt or equity is a court’s

8 In *Roth Steel Tube Co. v. Comm’r*, 800 F.2d 625 (6th Cir. 1986), the Court of Appeals for the Sixth Circuit laid out eleven factors to determine whether an investment was debt or equity in the context of assessing income tax liability. *Id.* at 630. *In re Autostyle Plastics* extended the use of those factors to the recharacterization context. 269 F.3d at 749-50. They are:

(1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation’s ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.

*Roth Steel Tube Co.*, 800 F.2d at 630.

The Courts of Appeal for the Eleventh and Fifth Circuits also employ a multi-factor test in the tax context. They have identified the following thirteen factors:

(1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) “thin” or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.

*Stinnett’s Pontiac Serv., Inc. v. Comm’r*, 730 F.2d 634, 638 (11th Cir. 1984) (citing *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972)).

*In re Cold Harbor Assocs., L.P.*, 204 B.R. at 915, discussed both of the above tests in the recharacterization context and applied the factors relevant to that case, and *In re Georgetown Bldg. Assocs.*, 240 B.R. at 137, cited with approval Cold Harbor’s use of these factors in the recharacterization context (but found it unnecessary to adopt formally a specific set of factors).


(1) the name given to the instrument; (2) the intent of the parties; (3) the presence or absence of a fixed maturity date; (4) the right to enforce payment of principal and interest; (5) the presence or absence of voting rights; (6) the status of the contribution in relation to regular corporate contributors; and (7) certainty of payment in the event of the corporation’s insolvency or liquidation.

attempt to discern whether the parties called an instrument one thing when in fact they intended it as something else. That intent may be inferred from what the parties say in their contracts, from what they do through their actions, and from the economic reality of the surrounding circumstances. Answers lie in facts that confer context case-by-case.

No mechanistic scorecard suffices. And none should, for Kabuki outcomes elude difficult fact patterns. While some cases are easy (e.g., a document titled a “Note” calling for payments of sums certain at fixed intervals with market-rate interest and these obligations are secured and are partly performed, versus a document issued as a certificate indicating a proportional interest in the enterprise to which the certificate relates), others are hard (such as a “Note” with conventional repayment terms yet reflecting an amount proportional to prior equity interests and whose payment terms are ignored). Which course a court discerns is typically a commonsense conclusion that the party infusing funds does so as a banker (the party expects to be repaid with interest no matter the borrower’s fortunes; therefore, the funds are debt) or as an investor (the funds infused are repaid based on the borrower’s fortunes; hence, they are equity). Form is no doubt a factor, but in the end it is no more than an indicator of what the parties actually intended and acted on.

C. Review of the District Court’s Recharacterization Holding

(1) Standard of Review.

We must first determine whether the District Court’s recharacterization conclusion is a finding of fact we review for clear error or a conclusion of law over which we exercise plenary review. Direct precedent on this issue is lacking, but several courts have considered this issue in the tax context.

In tax cases addressing whether for tax purposes a contribution should be treated as debt or equity, courts of appeal are split. The United States Courts of Appeals for the Sixth and Ninth Circuits have concluded the issue is one of fact to be reviewed for clear error. Roth Steel Tube, 800 F.2d at 629 (citing Smith v. Commissioner, 370 F.2d 178, 180 (6th Cir. 1966)); Bauer v. Commissioner, 748 F.2d 1365, 1367 (9th Cir. 1985) citing A.R. Lantz Co. v. United States, 424 F.2d 1330, 1334 (9th Cir. 1970). The Fifth and Eleventh Circuit Courts of Appeals, on the other hand, have held the issue to be primarily one of law subject to de novo review. Lane v. United States (In re Lane), 742 F.2d 1311, 1315 (11th Cir. 1984); Estate of Mixon v. United States, 464 F.2d 394, 402-03 & n.13 (5th Cir. 1972). In our Court, we were called upon to review a debt

9 Research has uncovered only one bankruptcy case discussing whether the capital contribution versus loan determination question is primarily one of law or fact. There the Court concluded that “the issue of classification of an advance presents a question of law subject to de novo review.” Celotex Corp. v. Hillsborough Holdings Corp. (In re Hillsborough Holdings Corp.), 176 B.R. 223, 248 (M.D. Fla. 1994) (citing Lane v. United States (In re Lane), 742 F.2d 1311 (11th Cir. 1984), a tax refund case).

10 Of course, it could be argued that the Eleventh Circuit did not reach this conclusion of its own accord. When the former Fifth Circuit was split into the Fifth and Eleventh Circuits on Oct. 1, 1981, the Eleventh Circuit adopted
versus equity determination in the tax context in *Gefman v. Commissioner*, 154 F.3d 61 (3d Cir. 1998), but we eschewed entering the thicket of deciding whether we were reviewing a finding of fact or a conclusion of law. See *id.* at 68 n.9.

As discussed above, the determinative inquiry in classifying advances as debt or equity is the intent of the parties as it existed at the time of the transaction. So framed, we agree with our Sixth and Ninth Circuit colleagues that this is a question of fact that, “once resolved by a district court, cannot be overturned unless clearly erroneous.” *A.R. Lantz Co.*, 424 F.2d at 1334.

(2) The District Court’s Determination Was Not Clearly Erroneous.

The District Court’s opinion includes ample findings of fact to support its recharacterization determination. Because these findings are not clearly erroneous and overwhelmingly support the Court’s decision to characterize the 1999 Fundings as debt (under any framework or test), we affirm its factual determination.

The District Court set out numerous facts to support a debt characterization. Looking to the lending documents, it found “beyond dispute in the record that…the name given to the 1999 fundings was debt…and…the 1999 fundings had a fixed maturity date and interest rate.” *In re SubMicron Sys.*, 291 B.R. at 325. The Court also found evidence of the parties’ intent to create a debt investment outside the lending documents. For example, it noted that “the 1999 notes were recorded as secured debt on SubMicron’s 10Q SEC filing and UCC-1 financing statements.” *Id.* at 319.

The District Court could not find, on the other hand, convincing evidence to support an equity investment characterization of the 1999 Fundings. It rejected Cohen’s argument that the dire financial circumstances surrounding the infusion of the 1999 Fundings supported an equity characterization. Instead, it concluded, with reference to the conflicting testimony and relative credibility of witnesses presented by both parties, that Cohen “failed to prove that[,] under SubMicron’s dire circumstances, [the Lenders’] transactions were improper or unusual [as debt investments].” *Id.* at 325. Recognizing that “‘when a corporation is undercapitalized, a court is more skeptical of purported loans made to it because they may in reality be infusions of capital,’” *id.* (quoting *In re Autostyle Plastics*, 269 F.3d at 746-47), the District Court also noted that “when existing lenders make loans to a distressed company, they are trying to protect their existing loans and traditional factors that lenders consider (such as capitalization, solvency, collateral, ability to pay cash interest and debt capacity ratios) do not apply as they would when lending to a financially healthy company,” *id.* Weighing these competing considerations, it did not find SubMicron’s undercapitalization greatly supported an equity characterization. *Id.*

Similarly, the Court found the Lenders’ participation on the SubMicron Board did not, in and of itself, provide support for an equity characterization. Again relying on expert testimony, it emphasized that it is “not unusual for lenders to have designees on a company’s board, as precedent the decisions of the Fifth Circuit handed down as of Sept. 30, 1981. *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981). Thus, *Mixon* was binding precedent for the *Lane* Court.
particularly when the company [is] a distressed one.” *Id.* at 325-26. After reviewing conflicting evidence on the issue, the Court concluded that Cohen “[did] not prove[] that [Lenders] or their designees controlled or dominated SubMicron’s Board in any way.” *Id.* at 326. Based on these factual determinations, the conclusion was inevitable that the Lenders’ representation on SubMicron’s Board did not necessarily support an equity characterization.

Lastly, the Court found unpersuasive Cohen’s argument that SubMicron’s failure to issue notes for the 1999 Tranche Two Funding should be understood as evidence of the parties’ understanding that the 1999 Fundings were, in effect, equity investments. It noted that “the record is clear that SubMicron’s accounting department made numerous mistakes and errors when generating notes,” concluding that “the fact that notes were generated for some fundings and not others is not sufficient, in and of itself, to recharacterize the 1999 fundings as equity.” *Id.* at 326.

In short, the District Court found ample evidence to support a debt characterization and little evidence to support a characterization of equity infusion. On the basis of these findings, which comport with the record, it was hardly clear error for the Court to conclude that “[Cohen] had not proven by a preponderance of the evidence that the 1999 Fundings should be recharacterized as equity.” *Id.* at 325.

IV. The 1999 Fundings Were Secured Debt

Having established that the District Court properly concluded the 1999 Fundings were debt, we turn to Cohen’s assertion that the Lenders did not present a valid secured claim. In determining whether claims asserted by creditors in bankruptcy are secured, state law applies. *See In re Bollinger Corp.*, 614 F.2d 924, 925 n.1 (3d Cir. 1980). Cohen concedes that, whether one applies Delaware, Pennsylvania, California or New York law, the requirements to obtain a security interest are the same. Thus each state’s codification of Uniform Commercial Code (“U.C.C.”) §§9-203 and 9-302 existing in 1999\(^\text{11}\) requires a written security agreement in favor of the lender describing the collateral and, for the collateral in question (inventory, equipment, receivables and general intangibles), the filing of a properly executed financing statement (unless the inventory and equipment are possessed by the lender or its representative, something normally, and here highly, impractical).

Cohen contends that the Lenders did not comply with state U.C.C. law (and thus the requirements for assertion of a secured claim). The main source of contention is that financing statements filed by the Lenders only list “Equinox Investment Partners, LLC, as Collateral Agent,” as the secured party.\(^\text{12}\) Cohen asserts that the listing of Equinox solely (and not also KB and Celerity) rendered the financing statement ineffective under the then-extant U.C.C.\(^\text{11}\) Since then, a revised Article 9 has been adopted in each state.

\(^\text{12}\) No claim is made that a security interest in the collateral was not created (the security agreements for the 1997 Notes and the 1998 Notes state that the collateral secures “the payment of all present and future indebtedness”), only that it was not properly perfected.
§9-402(1), which stated that a “financing statement is sufficient if it gives the names of the debtor and the secured party, is signed by the debtor, gives an address of the secured party from which information concerning the security interest may be obtained, gives a mailing address of the debtor and contains a statement indicating the types, or describing the items, of collateral.” Official Comment 2 to then—U.C.C. §9-402 indicated that Article 9 employed a “notice filing” system whereby financing statements needed only to indicate that a secured party “may have a security interest in the collateral described. Further inquiry from the parties concerned…[may] be necessary to disclose the complete state of affairs.” (Emphasis added.) In this context, “the Uniform Commercial Code does not require that the secured party as listed in [a financing] statement be a principal creditor and not an agent.” Indus. Packaging Prods. Co. v. Fort Pitt Packaging Int’l, Inc., 399 Pa. 643, 161 A.2d 19, 21 (Pa. 1960). Because the financing statements name both SubMicron as debtor and Equinox as secured party, provide mailing addresses for both entities, and describe the collateral that is subject to the security agreement, we conclude that any interested party would be on notice to communicate with Equinox regarding the status of its (and its principals’) interest in SubMicron’s assets. This is sufficient for Article 9 perfection purposes. Id.

We also conclude that, on the record before us, there can be no doubt that KB and Celerity were intended secured parties served by their agent, Equinox. Indeed, in the schedule of liabilities filed with the District Court, SubMicron lists KB and Celerity as secured noteholders. The District Court found on the basis of overwhelming evidence that KB and Celerity were intended secured parties with respect to the 1999 Fundings and we discern no basis to believe this determination was erroneous. In sum, we conclude that the Lenders presented valid secured claims for the 1999 Fundings.

V. Propriety of §363 Credit Bid

Having determined that the 1999 Fundings represented an extension of secured debt, we turn to Cohen’s argument that the §363(k) credit bid was improper because the Lenders did not (and could not) demonstrate that some portion of their claims remained secured by collateral as defined in Bankruptcy Code §506(a).13 The District Court determined that “there was no collateral available to actually secure the 1999 fundings.” In re SubMicron Sys., 291 B.R. at 327. As a result, Cohen argues that, because the secured debt had no actual (or economic) value, it could not be credit bid under §363(k). Because that section empowers creditors to bid the total face value of their claims—it does not limit bids to claims’ economic value—we disagree and hold that the District Court did not err in allowing the Lenders to credit bid their claims.

13 This provision reads in pertinent part:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest...is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property...and is an unsecured claim to the extent that the value of such creditor’s interest...is less than the amount of such allowed claim.

It is well settled among district and bankruptcy courts that creditors can bid the full face value of their secured claims under §363(k). See, e.g., In re Suncruz Casinos, LLC, 298 B.R. 833, 839 (Bankr. S.D. Fla. 2003) (“The plain language of [§363(k)] makes clear that the secured creditor may credit bid its entire claim, including any unsecured deficiency portion thereof. (emphasis in original)); In re Morgan House Gen. P’ship, 1997 U.S. Dist. LEXIS 1306, Nos. 96-M C-184 & 96-M C-185, 1997 WL 50419, at *1 (E.D. Pa. Feb. 7, 1997) (holding that secured creditors may bid “to the extent of [their] claim” under §363(k)); In re Midway Invs., Ltd., 187 B.R. 382, 391 n.12 (Bankr. S.D. Fla. 1995) (“[A] secured creditor may bid in the full amount of the creditor’s allowed claim, including the secured portion and any unsecured portion thereof” (citing legislative history) (alteration in original) (internal quotation marks omitted)); In re Realty Invs., Ltd. V, 72 B.R. 143, 146 (Bankr. C.D. Cal. 1987) (same); see also Criimi Mae Servs. Ltd. P’ship v. WDH Howell, LLC (In re WDH Howell, LLC), 298 B.R. 527, 532 n.8 (D.N.J. 2003).

In fact, logic demands that §363(k) be interpreted in this way; interpreting it to cap credit bids at the economic value of the underlying collateral is theoretically nonsensical.

A hypothetical is illustrative.

Assume that Debtor has a single asset: a truck, T. Lender is a secured creditor that has loaned Debtor $15, taking a security interest in T. Debtor is in Chapter 11 bankruptcy and has filed a §363 motion to sell T to Bidder for $10. Debtor argues that Lender can only credit bid $10 for T and must bid any excess in cash if it wishes to outbid B.

This hypothetical reveals the logical problem with an actual value bid cap. If Lender bids $12 for T, by definition $12 becomes the value of Lender’s security interest in T. In this way, until Lender is paid in full, Lender can always overbid Bidder. (Naturally, Lender will not outbid Bidder unless Lender believes it could generate a greater return on T than the return for Lender represented by Bidder’s offer.) As Lender holds a security interest in T, any amount bid for it up to the value of Lender’s full claim becomes the secured portion of Lender’s claim by
definition. Given the weight of reason’s demand that “it must be so,” we see no reason to catalog the myriad other arguments that have been advanced to support this “interpretation.”

Cohen is not out of plausible arguments, however, as he claims that because the Lenders were not partially undersecured but completely undersecured—that is, because the collateral was

14 Precisely this logical argument was presented in In re Realty Inv., Ltd V

An argument might be made that the “allowed claim” referred to in the Congressional Record is only the secured portion of [the creditor]’s claim. But this is an argument of form and not of substance.

Until [the nonrecourse undersecured lender] is paid in full, any bid received is subject to overbid by [the lender]. If [the bidder]’s bid were valued [below the full value of the lender’s claim], [the lender] could overbid it, and [the lender]’s bid would then become, by definition, the “allowed” claim…It is practical that [the lender] will bid in its entire obligation and therefore that its “allowed” claim. Because no one could buy the property without [the lender]’s consent, unless [the lender] is paid in full, the “allowed claim” of [the lender] must (for purposes of credit bidding) be its total claim without reference to the “value” of the property.

72 B.R. at 146

15 We pause nonetheless to note one such argument, in the mode of statutory interpretation, that is based on the exception for §363 sales contained in §1111(b)(1)(A)’s statutory protection for nonrecourse creditors (that is, in the event of the borrower’s default, the creditor may not look to the borrower for repayment, and thus is limited to its security, if any). The latter was “enacted by Congress to cure the harsh result of Great National Life Ins. Co. v. Pine Gate Associates, Ltd., 2 B.C.D. 1478 (Bankr. N.D. Ga. 1976).” Tampa Bay Assocs., Ltd. v. D RW Worthington, Ltd. (In re Tampa Bay Assocs., Ltd.), 864 F.2d 47, 49 (5th Cir. 1989). In Pine Gate, a secured creditor holding a nonrecourse lien against real property unsuccessfully objected to the bankruptcy sale of the property at a dramatically depressed price. The case made clear that “under the former Bankruptcy Act a debtor could file bankruptcy proceedings during a period when real property values were depressed, propose to repay secured [nonrecourse] lenders only to the extent of the then-appraised value of the property, and ‘cram down’ the secured lender class, preserving any future appreciation of the property for the debtor.” Id. at 50. Congress attempted to remedy this problem by enacting §1111(b)(1)(A), which “provides such creditors with an opportunity to elect to have their liens treated as recourse claims if their debtors intend to retain the property secured…” Id. The provision explicitly excepts sales of property under §363, however. 11 U.S.C. §1111(b)(1)(A)(ii).

The rationale for this exception presupposes that §363(k) credit bidders can bid the full value of their secured claims. “Congress intended to protect the nonrecourse undersecured creditor only if such a creditor is not permitted to purchase the collateral at a sale or if the debtor intends to retain the collateral after bankruptcy and not repay the debt in full.” In re Tampa Bay Assocs., 864 F.2d at 50. Congress deemed the undersecured nonrecourse creditor’s ability to credit bid the full value of his claim adequate protection in the §363 context, rendering §1111(b)(1)(A) unnecessary:

The legislative history verifies this congressional intent in limiting the applicability of the statutory recourse status: “Sale of property under [§] 363 or under the plan is excluded from treatment under [§] 1111(b) because of the secured party’s right to bid in the full amount of his allowed claim at any sale of collateral under section 363(k).”

Id. (quoting 124 Cong. Rec. H11,103-04 (1978)) (omission in original) (emphasis added). Because an undersecured nonrecourse creditor is protected to the full extent of its claim by virtue of its ability to bid up to the full value of that claim under §363(k), Congress concluded that §1111(b)(1)(A) need not apply to §363 sales.
found to have no economic value—this case is different. Yet nothing about the logic of allowing credit bids up to the full face value of the collateral changes if the collateral has no actual value. Because the Lenders had a valid security interest in essentially all the assets sold, by definition they were entitled to the satisfaction of their claims from available proceeds of any sale of those underlying assets. Their credit bid did nothing more than preserve their right to the proceeds, as credit bids do under §363(k).

Unable squarely to rest this argument on a theoretically sound construction of the Bankruptcy Code’s credit bidding provisions, Cohen enlists the aid of 11 U.S.C. §506(a), which provides for the splitting of partially secured claims into their secured claim and unsecured claim components. Yet §506(a) is inapplicable. As one member of the Supreme Court has explained, “when…the Bankruptcy Code means to refer to a secured party’s entire allowed claim, i.e., to both the ‘secured’ and ‘unsecured’ portions under §506(a), it uses the term ‘allowed claim’—as in 11 U.S.C. §363(k)” Dewsnup v. Timm, 502 U.S. 410, 422, 112 S. Ct. 773, 116 L. Ed. 2d 903 (1992) (Scalia, J., dissenting) (first emphasis in original). That is, §363(k) speaks to the full face value of a secured creditor’s claim, not to the portion of that claim that is actually collateralized as described in §506.

Moreover, as a practical matter, no §506 valuation is required before a §363 sale of the underlying collateral can be approved. Section 363 attempts to avoid the complexities and inefficiencies of valuing collateral altogether by substituting the theoretically preferable mechanism of a free market sale to set the price. The provision is premised on the notion that the market’s reaction to a sale best reflects the economic realities of assets’ worth. Naturally, then, courts are not required first to determine the assets’ worth before approving such a market sale. This would contravene the basis for the provision’s very existence.

For these reasons, we conclude that the District Court properly allowed the Lenders to contribute their credit bids under the §363 sale.

VI. Equitable Subordination

Cohen also argues that the Lenders’ claims related to the 1999 Fundings should be equitably subordinated to the claims of the general unsecured creditors. In Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims, we explained that:

before ordering equitable subordination, most courts have required a showing involving three elements: (1) the claimant must have engaged in some type of inequitable conduct, (2) the misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the claimant, and (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code.

160 F.3d 982, 986-87 (3d Cir. 1998) (citing United States v. Noland, 517 U.S. 535, 116 S. Ct. 1524, 134 L. Ed. 2d 748 (1996)). We declined, however, to adopt the first generally recognized element as a formal requirement for equitable subordination, noting instead that because the Bankruptcy Court in Citicorp Venture Capital properly found inequitable conduct, there was no
“need...[to] resolve the issue of whether misconduct is always a prerequisite to equitable subordination...”\textsuperscript{16} 160 F.3d at 987 n.2. In a similar vein, because the District Court found in our case, through a proper exercise of its discretion, that no injury resulted to SubMicron’s unsecured creditors as a result of the Lenders’ dealings with Akrion, we need not reach the issue of inequitable conduct in order to affirm the District Court’s equitable subordination holding.

As the District Court explained, the doctrine of equitable subordination “is remedial, not penal, and should be applied only to the extent necessary to offset specific harm that creditors have suffered on account of the inequitable conduct.” \textsuperscript{16}291 B.R. at 327 (citing Trone v. Smith (\textit{In re Westgate-California Corp.}), 642 F.2d 1174, 1178 (9th Cir. 1981)); see also \textit{Citicorp Venture Capital}, 160 F.3d at 991 (“A bankruptcy court should...attempt to identify the nature and extent of the harm it intends to compensate in a manner that will permit a judgment to be made regarding the proportionality of the remedy to the injury that has been suffered by those who will benefit from the subordination.”); \textit{Stoumbos v. Kilimnik}, 988 F.2d 949, 960 (9th Cir. 1993) (“A claim will be subordinated only to the claims of creditors whom the inequitable conduct has disadvantaged.”); \textit{Estes v. N & D Props., Inc. (In re N & D Props., Inc.)}, 799 F.2d 726, 733 (11th Cir. 1986) (stating that “equitable subordination operates only to redress the amount of actual harm done”).

Considering Cohen’s equitable subordination claim, the District Court held:

\textit{In re SubMicron Sys.}, 291 B.R. at 329.

\textsuperscript{16} Our hesitancy to adopt an inequitable conduct requirement in \textit{Citicorp Venture Capital} stemmed from our prior holding in \textit{In re Burden v. United States}, 917 F.2d 115, 120 (3d Cir. 1990), that “creditor misconduct is not [always] a prerequisite for equitable subordination.” As we explained, “\textit{Burden} involved subordination of a tax penalty in the absence of government misconduct.” 160 F.3d at 987 n.2.
The record supports the Court’s findings, and Cohen barely argues otherwise. 17 Further, Cohen points to no evidence showing that unsecured creditors were in any way disadvantaged or harmed by the sale of assets. 18 In this context, equitable subordination would serve no purpose and the Court thus properly denied Cohen’s claim.

As an aside, we note that Cohen recites the generalization that Delaware courts have held that directors’ fiduciary duties extend to creditors as well as shareholders once a debtor is in the “vicinity of insolvency.” Id. at 52 (citing Geyer v. Ingersoll Publ’ns Co., 621 A.2d 784, 789 (Del. Ch. 1992); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communs. Corp., 1991 Del. Ch. LEXIS 215, Civ. A. No. 12150, 1991 WL 277613, at *34 & n.55 (Del. Ch. Dec. 30, 1991)). The recent Delaware Chancery Court opinion of Vice Chancellor Strine in Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004), addresses the extent of director duties when a corporation is insolvent. Id. at 787-93. In so doing, the Vice Chancellor clarifies inaccurate generalizations of Credit Lyonnais that have gained traction from uncritical repetition.

We affirm the District Court’s approval of the §363 sale of SubMicron’s assets.

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17 While the last major heading in Cohen’s Opening Brief is that “The Record Contains Overwhelming Evidence That The Appellees Breached Their Fiduciary Duties and Their Claims Should be Equitably Subordinated,” Cohen Op. Br. at 51, little argument even implies the District Court’s findings were entered in error.

18 Indeed, it appears the 1999 Fundings benefited unsecured creditors by enabling SubMicron to pay operating expenses and to avoid a Chapter 7 liquidation.
CHAPTER 4
AN OVERVIEW OF THE AUTOMATIC STAY

It is sometimes said that the two primary objectives of chapter 11 are to maximize the going concern value of the bankruptcy estate and to assure equality of distribution among similarly situated creditors. The automatic stay, which comes into effect immediately upon the debtor’s bankruptcy filing without the need for any court order, is integral to chapter 11 because it halts further collection efforts. It preserves going concern value by preventing creditors from picking apart the debtor one asset at a time—the “death by a thousand cuts” that can convert an operating business into little more than a pile of spare parts.

At the same time, the automatic stay also helps to assure the second chapter 11 objective, equality of distribution, by preventing one creditor from seizing assets before others have an opportunity to do so. By putting all creditors on a level playing field, the stay replaces the chaotic “race to the courthouse” that would otherwise ensue in the absence of bankruptcy with an organized distribution scheme. Thus, the automatic stay protects not only debtors by providing some “breathing room” from their creditors, but it also protects the creditors from one another, and from the loss of going concern value.

As Bankruptcy Code sections go, §362 is easier than many to understand: §362(a) lists the actions that are stayed by the bankruptcy filing; §362(b) sets forth exceptions to the automatic stay; §362(c) describes the duration of the automatic stay; §362(d) sets forth the grounds for seeking relief from the automatic stay; §362(e) provides the time framework under which the courts must operate in response to a motion for relief from the automatic stay; §362(f) provides a limited mechanism for emergency relief from the stay where it is necessary to prevent irreparable harm; §362(g) allocates the burdens of proof in a motion for relief from stay; and §362(h) provides for damages in the event that a party willfully violates the automatic stay. Although much of what you need to know about the automatic stay can be learned by simply reading the statute, we highlight some of the more important provisions of §362, providing a discussion of the issues that are most often litigated and a bit of strategic advice.

What Is Stayed?

Bankruptcy Code §362(a) contains a long list of actions that are stayed by the filing of a bankruptcy petition. A brief perusal of this list will make it clear that the prohibited actions include those that tend to be of most concern to creditors. For example, after a debtor files bankruptcy, most of the time a creditor cannot file or continue to litigate a lawsuit against the debtor to recover on claims that arose before the petition date. Exceptions to this rule exist for residential eviction actions and other areas that were previously areas in which the automatic stay was abused. If a lawsuit has been filed against the debtor prior to the petition date, that lawsuit, at least as it relates to the debtor, must immediately halt. Typically, a debtor who is a defendant in pre-petition litigation will provide written notice to the court and other parties that the action is stayed shortly after it files its bankruptcy petition. Note that the automatic stay does not apply to
suits against the debtor based wholly on post-petition conduct; such suits can be filed in any court that has jurisdiction and are not implicated by the automatic stay.

The automatic stay precludes creditors from enforcing pre-petition judgments against the debtor; perfecting or enforcing liens granted pre-petition; foreclosing on collateral; terminating contracts on account of pre-petition defaults; or taking any number of other actions against the debtor or its property.

The automatic stay halts rights of setoff as well. Thus if a creditor and the debtor owe each other mutual pre-petition debts arising from different transactions, the creditor cannot, without relief from the stay, apply the debt owing to it against the debt it owes. However, if the debtor’s obligation to the creditor and the creditor’s obligation to the debtor both arise from the same transaction, the creditor may have a right of recoupment (a close relative to setoff). Courts hold that the right of recoupment is not subject to the automatic stay.

**Exceptions to the Automatic Stay**

Bankruptcy Code §362(b) lists exceptions to the automatic stay. These exceptions reflect policy decisions made by Congress that the rights of certain parties should take precedence over the debtor’s need for breathing room.

The most commonly implicated exceptions are: actions by parties to securities contracts to close out open positions; eviction of a debtor by a landlord where the lease has been fully terminated prior to the bankruptcy filing; actions by taxing authorities to conduct tax audits, issue deficiency notices, demand tax returns, and make tax assessments; enforcement of liens on real property that was subject to a bankruptcy case within the last two years; divorce, paternal child custody, or domestic violence proceedings; criminal cases; professional license suspension or termination proceedings; and perhaps the most common of all—the right of a governmental unit to enforce its police and regulatory power. See §362(b)(1)-(28).

A key issue that is often litigated in connection with this exception is whether the governmental unit is truly exercising its “police or regulatory” powers, or is instead simply acting as a creditor trying to collect a debt owed to the government. Courts have held that where a governmental entity acts to enforce its regulatory authority, such as protecting the public health, safety or welfare, its actions are exempt from the automatic stay. But where the government merely seeks to collect a debt, even if the entity doing so has regulatory authority, such an action is not exempt from the automatic stay, and the government must take its place in line just like any other creditor. Unfortunately, there is no bright line rule that would tell us precisely when the government is acting in a regulatory capacity as opposed to a creditor capacity.

Other exceptions to the automatic stay apply only to very highly specialized situations and you will rarely see them. These include, for example, state decisions regarding the licensing of educational institutions, certain ship and vessel mortgage foreclosures by the Secretary of Commerce or the Secretary of Transportation, and certain HUD mortgage foreclosures on multi-unit properties.
Finally, certain exceptions arise more frequently in individual bankruptcy cases than in corporate cases, such as criminal proceedings against the debtor, alimony and support proceedings, and residential eviction proceedings.

Is Stay Relief Necessary?

Practitioners are often called on to provide advice on whether a contemplated action would constitute a violation of the automatic stay and would thus require “relief from the stay.” Although the answer may be obvious in some cases, the following is a selection of some less clear-cut situations practitioners may encounter:

- a plaintiff believes that its lawsuit relates wholly to post-petition conduct, but the debtor alleges that it is based on pre-petition events;

- a creditor believes that it is exercising a right of recoupment (not subject to the stay), while the debtor characterizes the action as a setoff, which is subject to the stay;

- a party to a contract with the debtor believes that it has the right to terminate the contract based on a post-petition default without court approval, while the debtor takes the position that doing so constitutes an act “to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate,” and is therefore subject to the automatic stay;

- a creditor with a contract to supply goods to the debtor wants unilaterally to modify credit terms post-petition to minimize its risk, but the debtor argues that the unilateral contract modification violates the stay; or

- there may be a dispute over whether a transaction between the debtor and a counterparty constitutes a securities transaction of the type that is exempt from the stay.

These and other similar situations pose difficult strategic choices for the nondebtor party and its counsel. On the one hand, creditors often want to act quickly, and many believe that the court will be predisposed against them because it is charged with protecting the interests of the debtor and its estate. On the other hand, as discussed below, consequences for violating the automatic stay can be severe. Under these circumstances, many creditors opt to seek relief from the bankruptcy court as a precautionary measure. One approach is to file a motion seeking a determination that the stay does not apply or, in the alternative, relief from the stay.

How to Get Relief from the Automatic Stay

If a creditor believes that it qualifies for relief from the stay, it must seek such relief by filing a motion under §362(d). Such a motion is a contested matter, rather than an adversary proceeding and is governed by Bankruptcy Rule 4001.
Bankruptcy Code §362(e)(1) provides that the court may hold a preliminary hearing followed by a final hearing on a motion for relief from the stay, or may consolidate the two and just hold a single hearing. Except in particularly complex matters, as a practical matter, the courts tend to hold a single hearing, but local practices vary. The court must hold a preliminary hearing within 30 days after a motion for stay relief is filed, unless the movant agrees otherwise. If the initial hearing is a preliminary hearing, then a final hearing must be concluded by no later than 30 days after the conclusion of the preliminary hearing, unless the parties agree otherwise or the court finds “compelling circumstances.”

These provisions are intended to provide a prompt resolution of motions for relief from stay, recognizing that creditors who are entitled to relief from the stay often face substantial risk and imminent harm; justice delayed may be justice denied. But as you will see if you read §362(e), there is some room in the statute for delay, and while motions for relief from the stay are usually decided relatively promptly, that is not always the case.

Bankruptcy Code §362(e)(2) pertains to relief from stay in an individual’s case and sets up an automatic relief from the stay process on the sixtieth day after filing the motion unless the court orders otherwise for good cause or the parties agree otherwise. There are cases where a creditor will seek relief from the automatic stay on a very expedited basis. While counsel would be well advised not to invoke emergency proceedings unless there is a legitimate emergency (the fact that a client wants immediate relief is not, by itself, an emergency), where immediate relief is necessary to avoid irreparable harm, courts are often willing to give expedited consideration. See §362(f).

Bankruptcy Code §362(d) specifies the grounds for obtaining relief from the automatic stay. The first ground for obtaining relief from the automatic stay is set forth in §362(d)(1), which states that relief from the stay may be granted “for cause, including the lack of adequate protection of an interest in property…” As discussed in the previous chapter, secured creditors, and certain other parties that have an interest in property of the estate, are entitled to adequate protection to protect against diminution in the value of their collateral (or other property in which they have an interest) during the chapter 11 case.

For example, a mortgage lender whose pre-petition collateral is diminishing in value during the bankruptcy case may be entitled to periodic cash payments to compensate for the loss in collateral value. If a party is entitled to adequate protection, but the debtor is unable or unwilling to provide such adequate protection, this is a basis for relief under §362(d)(1) of the Bankruptcy Code.

You will note that §362(d)(1) refers to “cause, including the lack of adequate protection…” Thus, the statute appears to contemplate types of “cause” other than lack of adequate protection, although it does not say what they are. The lack of concrete enumerated types of “cause” (other than lack of adequate protection) justifying relief from the stay leaves the court with broad discretion in granting such relief. The following describes only a few examples of situations found to constitute “cause” warranting relief from stay: failure to maintain and preserve collateral; failure to keep collateral insured; waste or mismanagement; failure to pay taxes; and undue delay by the debtor in proposing a plan or reorganization.
Secured creditors who want to foreclose on their collateral are just one example of the universe of parties who often seek stay relief. Others include: contract parties who want to terminate contracts; litigants who want to continue with litigation or arbitration in a nonbankruptcy forum; and plaintiffs who want to name the debtor in a lawsuit in order to seek payment under an insurance policy. Of course, these are just a few examples. The concept of “cause” under §362(d)(1) is flexible enough to allow the court to balance the interests of the nondebtor party against the interests of the estate, and act accordingly.

The next basis for granting relief from the automatic stay is found in §362(d)(2). This section provides that a secured creditor may obtain relief from the automatic stay with respect to an act against property of the bankruptcy estate if, “(A) the debt or does not have an equity in such property, and (B) such property is not necessary to an effective reorganization.”

To meet the first requirement, the value of the property must not exceed the amount of all debts secured by liens on such property. This is what is meant by “an equity in such property.” The second factor requires a finding that the property is not necessary to an effective reorganization. This requirement may be satisfied either by showing that an effective reorganization may occur without the particular piece of property at issue or, alternatively, that the debtor is unlikely to successfully reorganize within a reasonable time (the definition of “reorganization” in this context is sometimes subject to dispute).

The third provision in §362(d)(3) deals with a special subsection of bankruptcy cases—single asset real estate bankruptcy cases. Single asset real estate bankruptcy cases are generally two-party contests. Secured creditors tend to argue that these are not “real” reorganization cases, and that it is unfair to impose delay and market risk on the secured creditor. Debtors, meanwhile—or in any event their partners or shareholders—use the breathing room afforded by the stay to wait for market improvement, seek to enhance value through leasing or going concern sale, or at least to delay the tax effects of a foreclosure, which can include recapture of prior credits and recognition of phantom income. This is, of course, a slight oversimplification of these cases, but nonetheless they are a special category of chapter 11 cases, and do not resemble the typical business reorganization contemplated by chapter 11.

Recognizing this, Congress enacted a special provision aimed at ensuring that these cases move quickly or, in the event that this does not happen, that the secured creditor nevertheless obtains relief. Bankruptcy Code §362(d)(3) provides that a secured creditor in one of these single asset cases is entitled to relief from the stay to foreclose on its collateral unless the debtor has filed a plan of reorganization that has a reasonable prospect for confirmation within a reasonable time period or begins paying monthly interest to the secured creditor at the non-default contract rate of interest by no later than 90 days after the bankruptcy filing (although the court has the power to extend this period). It used to be that this provision applied only to those single asset real estate cases involving less than $4 million in debt. However, since BAPCPA, it now applies to all single asset real estate cases.

Finally, the fourth provision in §362(d)(4) provides that with regard to the stay of an act against real estate (e.g., eviction or foreclosure), if the court finds that the case was filed as part of a scheme to delay, hinder, and defraud creditors either by transferring all or part of an interest
in the property without secured creditor consent or by multiple bankruptcy filings, the court may grant “in rem” relief from stay. That is, the court order granting relief from the stay could be recorded with local real property records in compliance with applicable recording statutes and it would be binding in a subsequent case involving the same property, subject to an opportunity for the new debtor to demonstrate changed circumstances. In rem stay relief orders are effective for up to two years after their entry by the bankruptcy court.

Stay Relief Strategy

The first strategic decision many creditors face with respect to the automatic stay is how early to seek relief. On the one hand, creditors of ten want to obtain relief quickly. First, doing so may minimize the delay and inconvenience resulting from bankruptcy. Second, they may want to seek relief early in the case before their collateral value begins to decline. Third, even if the secured creditor believes that it may not obtain relief from the stay, the creditor may want to file an early motion for relief from the stay in order to obtain adequate protection payments.

On the other hand, there may be a downside to moving too quickly. As a general matter, very early motions for relief from the automatic are more likely to fail than those filed later on in the case. Judges tend to be more concerned with the debtor’s rights early in the case and correspondingly less sympathetic to a non-debtor’s desire to immediately extricate itself from the bankruptcy. In fact, sometimes an early motion for relief from the stay will be seen by the court as an overly aggressive move by a secured creditor. The creditor risks that overzealousness will cause the judge to view him or her as unreasonable, and prejudice future arguments it may want to make.

As with any general principle, however, there will be times—such as where a creditor’s collateral value is eroding precipitously or where the requirements for stay relief can very clearly be demonstrated—where circumstances justify seeking early relief from the stay. It may therefore be appropriate to bring an early motion for relief from stay so that it can either be denied or settled with the debtor making representations about its ability to reorganize quickly and efficiently. These statements can later be used in support of a second motion for relief from stay when the debtor’s rosy prospects and predictions do not come to pass. But in most circumstances, the creditor must carefully balance a desire for prompt relief against preserving greater chances for success later in the case.

Bankruptcy Code §362(g) sets out the movant and non-movant’s respective burdens in a motion for relief from stay as follows: the party requesting relief from the stay has the burden of proof on the issue of whether the debtor has equity in the property (see §362(d)(2)), but the party opposing relief from the stay has the burden of proof on all other issues. As a practical matter, however, both the movant and the responding party are well-advised to be prepared to present evidence on all of the relevant issues.

In order to streamline a hearing on a motion for relief from stay, it is sometimes possible for the parties to stipulate on issues for which there is no real dispute. For example, sometimes the parties are able to avoid lengthy valuation evidence by stipulating as to the value of certain collateral. It makes sense to look for opportunities to reduce the matters being disputed, as long
as such an agreement does not prejudice your case. If nothing else, the judge is likely to appreciate being spared long presentations on uncontested or peripheral issues.

Sometimes a creditor or a debtor will use a motion for relief from the automatic stay to presage arguments that they may want to make later in the case, including at the plan confirmation stage. The creditor, for example, may want to use the opportunity to show that the debtor has little prospect for successful reorganization. Or the debtor may use an early lift stay motion to outline its preliminary reorganization plans and efforts. This can be a useful litigation strategy, but it pays to carefully measure any arguments you forward at an early lift stay hearing lest these arguments come back to bite you later on in the case.

For example, a secured creditor may want to claim that it is undersecured at an early lift stay hearing to show that its position is at risk. However, if that creditor fails to obtain relief, it may later want to take the position that it is oversecured in order to obtain post-petition interest under §506(b). Thus, at a lift stay hearing a lawyer must not only be aware of his or her present arguments, but also take heed to preserve arguments that may become necessary later on in the case.

Finally, it is incumbent upon lawyers for nondebtor parties to caution their clients not to violate the automatic stay. A creditor will ordinarily not be punished for inadvertent violations of the automatic stay, although actions taken in violation of the stay are void as a matter of law. Under §362(k), however, the bankruptcy court may extract damages, including attorney’s fees and even punitive damages, from a party who willfully violates the automatic stay. There are few more effective ways to paint yourself as a “bad actor” in the eyes of the court than to willfully violate the automatic stay.
This edited order illustrates the operation of the automatic stay process of attempting to obtain relief from the stay.

**LA JOLLA MORTGAGE FUND v. RANCHO EL CAJON ASSOCS.**

**UNITED STATES BANKRUPTCY COURT**
FOR THE SOUTHERN DISTRICT OF CALIFORNIA

**18 B.R. 283 (1982)**

I.  

On Jan. 6, 1982, the plaintiff, La Jolla Mortgage Fund ("Fund"), filed this complaint seeking relief from the automatic stay. In the complaint, the Fund claimed that there is no equity in the property, which constitutes the collateral for two notes held by the Fund, and that the property is not necessary for an effective reorganization of the defendant-debtor, Rancho El Cajon Associates ("Debtor"). The plaintiff also urged relief on the ground that the Debtor had failed to provide adequate protection for the Fund’s interest in the property.

On Jan. 20, 1982, the Debtor requested a hearing claiming that there was equity in the property, and it was necessary for an effective reorganization. His was followed by a formal answer, which was filed on Jan. 28, 1982.

A preliminary hearing was scheduled to be held on Feb. 2, 1982. At that hearing, counsel for both parties agreed to waive the preliminary hearing, allowing the stay to remain in place, and reserve all issues until the final hearing could be held. The final hearing was held before this Court on Feb. 25, 1982. At the conclusion of the final hearing, this Court ruled that the automatic stay should be lifted. This opinion is filed to explain this ruling granting relief to the plaintiff.

II.  **Facts**

The plaintiff is the holder of two notes secured by deeds of trust on a single family residence, which was constructed by the debtor-partnership at 7881 Cimarron Lane in the City of La Mesa, California. These notes became all due and payable on July 2, 1981. The Debtor defaulted by failing to make the necessary payments on these notes, and the plaintiff recorded notices of default on July 13, 1981. This precipitated the debtor’s filing this chapter 11 proceeding on Oct. 16, 1981.

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1 [Seeking relief from stay via complaint is an old practice that has been abolished. The substance of proceeding via motion, however, is identical. Eds.]
At the final hearing, it was stipulated by the parties that the total amount now due on the obligations due to the plaintiff is $108,824.17, including principal, accrued interest and other charges. In addition, the parties agreed that there exists a junior lien on the property, in favor of the Imperial Bank, for a note in the amount of $38,000, including accrued interest. Thus, the total encumbrances against the subject property amount to $146,824.17.

To establish the value of the property, the plaintiff presented an appraiser who valued it at $110,000. The Debtor presented its own appraiser who calculated that the property had a fair market value of $145,000.

One of the Debtor’s general partners testified that the property has a value of $160,000, even though the property has been listed for sale at only $145,000.

III. Significant Issue Presented

Whether junior secured claims are to be considered in calculations concerning the existence of a “value cushion,” as adequate protection under 11 U.S.C. §362(d)(1), and in determining the existence of equity in property under 11 U.S.C. §362(d)(2)(A).

IV. Discussion

The Bankruptcy Code is designed to allow chapter 11 debtors time in which to formulate a plan of rehabilitation, free from creditor pressure. The device used to promote this goal is the automatic stay, which enjoins most creditor action against the debtor and its property, and thereby, prevents a chaotic and uncontrolled scramble for the debtor’s assets, and grants a “breathing spell” for debtors to regroup. See 11 U.S.C. §362(a). Of course, the automatic stay acts to frustrate the creditors with secured claims, for they are deprived of a basic ingredient of their bargain, the right to resort to the collateral in satisfaction of the debt. The Bankruptcy Code provides a vehicle with which these creditors can test the continued need for the stay, by requesting relief from the stay under §362(d), which reads:

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

(2) with respect to a stay of an act against property, if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.
11 U.S.C. §362(d). The Fund has filed its complaint under this section and has requested relief under both subsections of this provision. It alleges under §362(d)(1) that there is cause to lift the stay, as its interest in the subject property is not adequately protected, and under §362(d)(2) the Fund claims that the Debtor has no equity in the property and that it is not necessary for an effective reorganization of the debtor. Since these remedies are phrased disjunctively in the statute, the Fund need only prevail on one of these alternatives to obtain relief.

A. Adequate Protection

Under §363(e) of the Bankruptcy Code, an entity having an interest in property, which the debtor proposes to use, is entitled to adequate protection of its interest. Congress advanced the concept of adequate protection because, though the creditor might not receive his bargain in kind, the purpose of the provision is to insure that the creditor with a secured claim receive in value essentially what he bargained for. It is derived from the Fifth Amendment protection of property interests and, as such, it must be completely compensatory.\(^2\)

The creditor’s right to adequate protection is limited to the lesser of the value of the collateral or the amount of the secured claim. While there is some debate as to the operative date for making the necessary calculation of the amount of the claim entitled to adequate protection, it appears that the value on the date, on which the petition commencing the case is filed, should be the benchmark for this purpose. In enacting the Code, Congress enumerated three non-exclusive examples of how adequate protection may be required in §361, as follows:

1. requiring the trustee to make periodic cash payments to such entity, to the extent that the stay under §362 of this title, use, sale, or lease under §363 of this title, or any grant of a lien under §364 of this title results in a decrease in the value of such entity’s interest in such property;

2. providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity’s interest in such property; or

3. granting such other relief, other than entitling such entity to compensation allowable under §503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity’s interest in such property.

\(^2\) However, it should be noted that the adequate protection provision is not designed to put the holder of a secured claim in the same position as when the transaction was initially negotiated. See In re Hutton-Johnson Co., Inc., 6 B.R. 855, 860 (S.D.N.Y. 1980).
Here, the Debtor has simply proposed that the collateral itself has sufficient value to constitute adequate protection of the Fund’s interest. Shortly after the Bankruptcy Code became effective, this Court in *In re San Clemente Estates, 5 B.R. 605, 6 B.C.D. 838 (Bankr. S.D.Cal. 1980)*, recognized that in appropriate cases the value of the collateral itself could provide adequate protection. Both this Court, and others, referred to this as the “equity-cushion” approach. It has been defined as value in the property above the amount owed to the creditor with a secured claim, that will shield that interest from loss due to any decrease in the value of the property during the time the automatic stay remains in effect. While this approach is valid, the instant case demonstrates that the phrase “equity cushion” is a misnomer. By including the word “equity,” we have created some confusion. “Equity” is the value, *above all secured claims* against the property, that can be realized from the sale of the property for the benefit of the unsecured creditors. Under the requirements of §362(d)(2)(A), equity in the debtor’s property, or lack thereof, can be relevant and under §362(g)(1) the creditor, as the party requesting relief, has the burden of proof on the issue of the existence of equity. However, in considering whether the Debtor has provided adequate protection for a creditor’s secured claim, we are not concerned with the availability of equity for unsecured creditors. Instead, we are concerned with whether there is sufficient value in the collateral to protect the secured claim from diminution. A more apt and descriptive phrase would be “value cushion.”

Of course, since this is a question of providing adequate protection, the Debtor has the burden of proof. Here, the party seeking relief from the stay, the Fund, did take the initiative on the value of the subject property, as it was striking for relief under both prongs of §362(d). If it had not placed the issue of equity in question, then the burden would have been entirely on the Debtor, even on the question of value, in its quest to keep the stay in place. See 11 U.S.C. §362(g)(2).

It should be noted that each case must be approached in light of its individual circumstances. Obviously, the situation involving a greatly oversecured claim will be quite different from the case of an undersecured claim. In the latter case, where the collateral is worth less than the debt, then the claim is secured only to the extent of the value of the collateral, with the remainder being considered as an unsecured claim. If the “value cushion” is small, or if we have an undersecured claim, and the value of the property is not on the rise, then the Court must be more particular concerning the adequacy of the offered protection, especially when it is simply the collateral itself. In such marginal situations, the collateral alone may not be enough, even at an early stage of the proceedings. A debtor may have to offer more than just the property, if it wishes to prevail. Again, each case will have to be decided on its individual facts, noting that, on this, one of our colleagues has opined that a particular value cushion which “may be adequate protection for a third or fourth mortgagee in one case, may be insufficient to constitute adequate protection for a first mortgagee in another case.”

Turning now to the valuation to be attributed to the subject property. At the trial, the parties strongly contested this question. Since the term “value” is an elusive and illusory concept, this Court can only endeavor to make a reasonable determination based upon the evidence, including the opinions of the two expert witnesses, presented during this trial. This valuation process is not an exact science and the Court must consider estimates and approximations.
founded upon opinions and assumptions. *In re Tucker, supra, 5 B.R. at 182, 6 B.C.D. at 701*. As Judge Ordin has put it:

(w)e deal here in likelihoods and probabilities. We do not have techniques or paraphernalia with which to make evaluations or predictions with the finite exactitude known to the laboratory.

*In re Pitts, 2 B.R. 476, 478, (Bankr. D. Utah 1981)*. This difficulty is further complicated by the large differences of opinion often found in expert appraisal testimony. Here, the appraisals presented show an unusually large difference of opinion in light of the fact that this property is a recently constructed single family residence located in a well-settled local community. The Fund’s expert testified that the property should carry a fair market value of no more than $110,000. The Debtor’s expert witness contradicted this evaluation and suggested that a truer value would be at $145,000. After reviewing all the evidence, this Court must recognize that the currently depressed housing market requires that the Debtor’s estimate be reduced by 15 percent to reflect a more prudent and realistic value, one that could be obtained in a reasonable time in this market. This value of $123,250 must be further reduced by an amount sufficient to cover the usual costs of foreclosure and sale. The Debtor’s counsel suggested that this deduction be limited to three percent, since it is hoped that one of the Debtor’s partners will act as a broker in any sale, thereby achieving a savings for the estate. This is not appropriate, for this Court must deduct a sufficient sum to assure that the usual costs incurred in foreclosure and sale will not compromise the allowed secured claim. In this regard, we must evaluate the collateral, being the adequate protection, in the hands of the claim holder. It is the creditors’ expected costs to liquidate the property that is relevant, not those of the Debtor. Here, a more realistic estimate of such costs would be to deduct seven percent from the fair-market value to cover these costs, leaving a net value of $114,623.

This brings us to a significant issue raised by the Fund. It argues that in calculating whether its interest is adequately protected by the value of the collateral it is necessary to consider the junior secured claim in the analysis. The Debtor would dispute this approach and argues that this Court should disregard the junior claim, for all purposes, in this action. If the Fund is correct, then this Court would have no choice but to determine a lack of adequate protection, for if all secured claims are considered, it is clear that they exceed the property’s value by over $30,000.

However, this Court must reject the Fund’s position. The Fund is only entitled to have its secured claim adequately protected, not those of junior claim holders. If the party seeking relief receives the indubitable equivalence of its interest, then the Debtor has sustained its burden of providing adequate protection, even in cases where the junior claims are not so protected. 11 U.S.C. §361. Thus, here the net fair-market value is $114,623, with the Fund’s claim being $108,824.17, leaving a “value cushion” of $5,798.83. Given the inexactitude inherent in the value calculation in our present economy, it is doubtful that this cushion would be sufficient to provide adequate protection for more than a very short period of time. However, given our conclusion on the Fund’s claim for relief under 11 U.S.C. §362(d)(2) (see below), this Court
finds it unnecessary to make a final determination concerning how long the stay could remain in effect.

**B. Debtor’s Equity in Property and Need To an Effective Reorganization**

In addition to challenging the Debtor’s offer of adequate protection, the Fund relies on §362(d)(2), which is limited to cases, such as this, involving a stay of acts against property. This provision was added to the Bankruptcy Code as a direct response to situations involving real property mortgage foreclosures where the petition for relief is filed in the Bankruptcy Court on the eve of the foreclosure. The effect of this section, then, is to allow creditors to immediately proceed against the property where the debtor has no equity, and it is unnecessary to the reorganization, even where the debtor can provide adequate protection under §362(d)(1). This provision produces the salutary result of redirecting the debtor’s attention away from properties which can be of no help in the reorganization effort and, thus, helps conserve the debtor’s energies for the more critical and, hopefully beneficial, issues presented in the chapter 11 proceedings.

The first question we present is whether the debtor has any equity in the subject property. On this, and nothing else, the party requesting relief has the burden of proof. 11 U.S.C. §362(g).

The net value of the property has been determined by this Court to be $114,623. Against this, the Fund urges this Court to consider all outstanding encumbrances on the property. The Debtor, of course, argues that the junior secured claim should not be considered. It appears that there exists a difference of opinion among the Bankruptcy Courts on this question. Judge King of Philadelphia, in a case involving a claim for relief under 11 U.S.C. §362(d)(2), has declared that in determining whether equity exists “in the subject property, all encumbrances are totaled, whether or not all the lienholders have joined in the request from the stay.” In re Mikole Developers, Inc., supra, 14 B.R. at 525. Accord, In re Gardner, supra, 14 B.R. at 456 (King, J.). See also In re Dallasta, supra, 7 B.R. at 883 (King, J).

While Judge King’s opinions support the Fund, there are two published opinions which appear to support the Debtor’s view. In Matter of Spring Garden Foliage, Inc., 15 B.R. 140, 143 (Bankr. M.D.Fla. 1981), Judge Paskay emphatically takes a view in support of the Debtor’s position. See also In re Woford Enterprises, Inc., supra, 11 B.R. at 571. Judge Paskay is correct when he notes that there is nothing in the legislative history to provide guidance in resolving this issue. 15 B.R. at 143. However, this Court finds itself in complete accord with the holdings of Judge King, that all secured claims are totaled to determine equity under §362(d)(2)(A), whether or not all secured claim holders have requested relief from the stay, although a different rule should govern questions of adequate protection under §362(d)(1). As we noted in our discussion on adequate protection, the term “equity” as used in §362(d)(2)(A), must mean the value, above all secured claims against the property, that can be realized from the sale of the property for the benefit of unsecured creditors and equity security holders. See 11 U.S.C. §101(16). This is in accord with the policy determination that a “chapter 11 reorganization should serve to benefit the Debtor’s interests and not exclusively those of junior lienors.” In re Saint Peter’s School, 16 B.R. 404 (Bankr. S.D.N.Y. 1982) Where no value will be realized to contribute to the
reorganization effort, the Debtor should not be able to protect property unless it can show it is essential to achieving the reorganization goal.

In this, the Debtor argues that this property is needed in its reorganization. If the Debtor can sustain its burden of proof on this issue, relief from the stay will not be granted under §362(d)(2), even though there is no equity in the property.

Under §362(d)(2)(B), the stay would be lifted if the “property is not necessary to an effective reorganization.” 11 U.S.C. §362(d)(2)(B). On this point:

it is not enough for a debtor to argue that the automatic stay should continue because it needs the secured property in order to propose a reorganization. If this were the test all property held by debtors could be regarded as necessary for the debtor’s reorganization. The key word under §362(d)(2)(B) is “effective”; the property must be necessary to an effective reorganization. If all the debtor can offer at this time is high hopes without any financial prospects on the horizon to warrant a conclusion that a reorganization in the near future is likely, it cannot be said that the property is necessary to an “effective” reorganization.

In re Clark Tech. Associates, Ltd., 9 B.R. 738 740 (Bankr. D. Conn. 1981). See In re Dublin Properties, 12 B.R. 77, 78, 80 (Bankr. E.D. Pa. 1981) (reorganization must be “realistically possible”). Thus, the Debtor must show that a reorganization can be anticipated, and that this property has a part to play in the reorganization plan.

To sustain its burden, the Debtor has proffered the argument that lifting the stay would likely result in the Fund foreclosing on the property and possibly “selling out” the junior secured claim. If this were to happen, the Debtor argues, then the junior creditor could then file a substantial unsecured claim for any deficiency. The Debtor is correct that under California law a holder of a nonpurchase-price money note and deed of trust in a junior position can file a claim for any deficiency when “sold-out” by a senior encumbrance. See Cal. Code Civ. Proc. §580b. This is, of course, just one aspect of the continuing problem of junior secured claims being “squeezed” by senior claims. Now, the theory of the Debtor’s argument has considerable merit. If the Debtor can satisfy certain claims in whole, or in part, from property that has no equity and which has no particular place in the reorganization effort beyond its value in being able to satisfy the claims it secures, then, the Debtor may have more flexibility in dealing with the remaining claims with the other assets available. Obviously, such a development would not be for the exclusive benefit of the junior secured claims, for the Debtor would derive the very tangible advantage in easing its reorganization labors.

The problem with the Debtor’s argument in this case is the complete failure of the Debtor to present evidence that would support the finding that reorganization is likely and to explain how the minimal value in this property could be useful here in the reorganization. It does not appear, even under the most optimum circumstances, that this property could produce any
significant reduction in any Imperial Bank claim. Given this failure of proof, this Court must conclude that the subject property is not necessary to an effective reorganization.

V. CONCLUSION

Relief must be granted, under 11 U.S.C. §362(d)(2), in this action to lift this stay of acts against property, as the Debtor has no equity in the property and it is not necessary to an effective reorganization.
CHAPTER 5
AN OVERVIEW OF BANKRUPTCY LITIGATION

Things generally move at a much faster pace in bankruptcy than in nonbankruptcy litigation. This is true for one good, practical reason: the debtor in bankruptcy is sick, and if you fight too long over the patient, you’ll have nothing left but a corpse. The upshot is that bankruptcy is in many ways a livelier and more dynamic forum than the nonbankruptcy realm. But for the experienced litigator, practicing in bankruptcy can be like trying to speak Italian when you studied Spanish in school. You keep thinking you speak the language, but every so often you get an unexpected, and often nasty, surprise.

In short, general civil litigation and bankruptcy litigation may appear at first blush to be largely the same, but when you look beneath the surface, there are important differences.

Start with the “case.” Litigators try cases. But in bankruptcy, the “case” isn’t really a litigation matter. A chapter 11 “case” is better thought of as a forum in which many smaller pieces take place. Some of those pieces involve contests in court; many more involve negotiation among interested parties.

Although lawyers do not litigate “bankruptcy cases” themselves, there can be plenty of litigation inside the case. First, there may be lawsuits within the bankruptcy case. For example, the trustee may sue nondebtors to collect assets for the estate, or to undo avoidable transfers. Less frequently, someone may sue the debtor, or even the trustee. These proceedings will look like traditional litigation, but if you spend much time in bankruptcy court, you will see differences. Some of these differences are substantive, while others involve terminology.

Adversary Proceedings

The first difference of terminology involves the name of the action. The bankruptcy name for a lawsuit filed in the bankruptcy case is “adversary proceeding.” You will see this on the face of the complaint. For example, if Smith is the debtor and Jones is the trustee, suing Brown, the caption will say: In re Smith (the case name) and Jones v. Brown (the adversary proceeding name). The pleading will bear a “case” number (referring to the bankruptcy case) and an “adversary number” referring to the lawsuit-within-the-case.

Aside from adversary proceedings, there are plenty of instances where a bankruptcy case may generate conflict and litigation that does not result in an “adversary proceeding.” For example, a creditor might seek relief from the automatic stay to foreclose on its collateral. Or the DIP might want to assume (or reject) an executory contract. Or a chapter 11 debtor may seek to confirm a plan to which creditors are objecting.


Contested Matters

The bankruptcy term for these situations is “contested matters.” Again, you can tell the difference from the face of the pleading. Adversary proceedings begin with a “complaint” just like a “case” under the Federal Rules of Civil Procedure. “Contested matters” begin with a motion or, occasionally, an application. They don’t get their own number, and they don’t get that special two-headed caption.

So if the trustee in Smith’s case wants to assume an executory contract, the caption will say “In re Smith,” and will bear the title: “Trustee’s Motion to Assume Executory Contract” (or words to that effect). Contested matters tend to proceed more quickly, and somewhat less formally, than adversary proceedings, although they can still result in discovery and in trials before the bankruptcy judge.

Some proceedings go before the court only if an interested party objects. The DIP notifies parties of its intention and if nobody objects, it can go ahead and do what it proposes. For example, the DIP may abandon property of the estate on “negative notice” to parties-in-interest. Similarly, the Code provides that the DIP may sell property of the estate without court order if it has given the right kind of notice and no one objects.

But many lawyers and clients find they can’t live with that uncertainty (what will the title insurance company say?). So in many places, the courts will issue comfort orders (e.g., “Order Approving Sale”) even though there is no contest before it and even though the Code doesn’t seem to require a court order.

“Notice and a Hearing”

This describes the basic framework. Now, for the law. Where do we find the rules that govern bankruptcy litigation? The answer is—not in the Bankruptcy Code. For the most part, the Code sidesteps questions of mechanics. Instead, it directs, repeatedly, that something or other may be done “after notice and a hearing.”

Bankruptcy Code §102(1) defines the phrase “after notice and a hearing” to mean after:

“such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances…”

This doesn’t tell you anything helpful. But the point is that the Code doesn’t pretend to tell you anything specific on the point: rather, matters of procedure are handled outside the Code in the Bankruptcy Rules (of which more infra).

But it is a little trickier than that. Note that the rule doesn’t require a hearing. Rather, “hearing” actually means “opportunity for a hearing.” The drafters intended matters to go without hearing if it was “appropriate” to do so. Subsection (1)(B) fleshes out the point. This subsection says that “after notice and a hearing”
(B) authorizes an act without an actual hearing if such notice is given properly and if—

(i) such a hearing is not requested timely by a party in interest; or

(ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act.

As a practical matter, a lot of things in bankruptcy happen just this way: Someone gives notice of an intention to do something; no one objects, and so the moving party goes forward without a hearing. (A classic example of this is a trustee’s notice of intention to abandon property, referred to above).

Beyond this somewhat slender principle, we must look outside the Bankruptcy Code for answers to our procedural questions. Your first stop should be the Federal Rules of Bankruptcy Procedure (often referred to as the “Bankruptcy Rules” or the “FRBP”). And here again, we encounter a potential language barrier. The Bankruptcy Rules look like the Federal Rules of Civil Procedure; indeed the Bankruptcy Rules incorporate a good many of the Federal Rules, but not all, as we shall see. And this is where the neophyte can run into trouble if she looks at the rules on a cursory basis and assumes she already speaks the language.

The easiest way to approach the rules is in the framework we sketched out above. Start with “adversary proceeding”—the lawsuit-within-a-case. For an “adversary proceeding,” the governing rules are in Part VII (the “Adversary Rules” or as some say, the “7000 Series”) of the Bankruptcy Rules, starting with Rule 7001. Here, mercifully, litigators are on largely familiar territory: the Bankruptcy Rules bear considerable similarity to the Federal Rules of Civil Procedure. Indeed, Adversary Rules simply “adopt by reference” many of the Federal Rules of Civil Procedure.

Rule 7001 lists forms of relief that parties may only obtain through adversary proceedings. The list includes actions:

- to recover money or property.
- to determine discharge or dischargeability.
- to determine the validity or priority of liens.
- to get an injunction.
- to subordinate a claim.

Some matters “not on the list” have their own rules framework: e.g., the rules governing the process of confirmation for a chapter 11 plan (Rules 3018 through 3021). Some fall under the
more general rubric of “contested matters” governed by the rules in Part IX of the Bankruptcy Rules, particularly Rule 9014.

The distinction can seem arbitrary—why, for example, is an action to assume or reject an executory contract a mere “contested matter,” while an action to avoid a lien is an “adversary proceeding?” But there may be less here than meets the eye. Rule 9014 specifies a number of Adversary Rules that apply to contested matters as well as adversary proceedings. And it provides that the judge may apply any of the other Adversary Rules if she chooses.

One noteworthy provision in these rules, provided in Bankruptcy Rule 7004, allows nationwide service of process by mail. This provision is a good deal more liberal than the parallel one contained in nonbankruptcy rules. The practical effect of Rule 7004 is that a plaintiff commencing an adversary proceeding can just drop the summons and complaint in the mail to the defendant—any place in the United States—and this will constitute adequate service.

Oddly, the rule governing “service of process” does not extend to the issuance of subpoenas. Rule 9016 governs subpoenas, incorporating by reference Federal Rule of Civil Procedure 45, which is much less expansive. As litigators will recognize, Rule 9016 limits service of subpoenas (in most instances) to the district of issuance or to within 100 miles of the place designated for response to the subpoena.

Another point of familiarity to the general litigator is the matter of evidence. Bankruptcy Rule 9017 provides that the Federal Rules of Evidence apply in bankruptcy cases. And Bankruptcy Rule 9014(d) provides that “testimony of witnesses with respect to disputed material factual issues shall be taken [in contested matters] in the same manner as testimony in an adversary proceeding.”

As a matter of history, bankruptcy has a tradition of laxity about matters of evidence. There is a tradition in bankruptcy wryly nicknamed “testimony from the podium,” describing situations in which the judge bases her decision upon attorney proffer rather than sworn testimony (“Your honor, if called to testify, my client would say…”).

Our observation is that practice has tightened up some in recent years, and that the judge will often compel counsel in bankruptcy proceedings to comply with basic evidentiary rules just as in any other court. In fact, a litigator who has a firm grasp of the rules of evidence will often have a distinct advantage over her bankruptcy counterparts, simply because bankruptcy lawyers tend to be less familiar with the rules of evidence.

Nevertheless, practice remains a bit more fluid and informal in many bankruptcy courts compared to what you would encounter in federal district or state trial courts. One possible reason for this is the general absence of juries; because there is no jury to poison, the judge may simply permit witnesses to tell their stories, confident in his ability to later disregard any inadmissible portions. Another explanation is that bankruptcy judges tend to look for practical business solutions, and may be more concerned about reaching a commercially appropriate result than being bogged down with a “technical” dispute about the admissibility of any particular piece of evidence.
As you might expect, lawyers will encounter substantial variation among judges with regard to the level of formality in their courtrooms and the extent to which they require strict compliance with the rules of evidence or demand complete evidentiary records to support factual findings. An understanding of the courtroom procedures and practices of the judge in your case is essential. Counsel must also consult Local Bankruptcy Rules. In most instances, these are available on the court’s Web site.

Aside from the Adversary Rules and the rules regarding motions, there are a number of other rules that may apply to particular bankruptcy-related matters. Many of these govern bankruptcy-specific issues—such as filing schedules or filing and objecting to proofs of claim. An indispensable (but by no means exhaustive) set of deadlines is set forth in Rule 2002. Another important rule relating to dates and deadlines that bankruptcy litigators should be aware of is Rule 9006, particularly subsections (b) and (c), which dictate which other deadlines in the Bankruptcy Rules may be modified by the judge, and which may not.

**Rule 2004**

One Bankruptcy Rule of particular notoriety is Rule 2004, with the anodyne title of “examinations.” Rule 2004 gives “any party in interest” the right (on court order) to examine “any entity.” The examination “may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor’s estate, or to the debtor’s right to a discharge.” The inclusion of the word “only” strikes your authors as somewhat Pickwickean.

The rule prohibits us from asking for a prediction as to the Red Sox’s chances of winning a World Series (assuming the debtor has no stake in the series), but it is hard to imagine much else that would fall outside the scope of such a broadly worded rule. (In fact, parties seeking broad Rule 2004 examinations are fond of citing language from some published decisions referring to such examinations as “fishing expeditions”).

Rule 2004 might appear unnecessary given that the Bankruptcy Rules already incorporate the discovery rules that have been transplanted in their entirety from the Federal Rules of Civil Procedure. Why do we need both? Well, Rule 2004 appears to authorize examination outside the context of an adversary proceeding or contested matter.

Indeed, when there is a pending adversary proceeding, the judge may deny a Rule 2004 order relating to the subject of the adversary proceeding, telling the parties to use ordinary litigation discovery procedures instead. Sometimes a party will use Rule 2004 to obtain information necessary to decide whether to bring an adversary proceeding. This sort of pre-complaint discovery is rarely available in nonbankruptcy litigation.

One Bankruptcy Rule that is central to chapter 11 practice is Rule 4001, dealing with three matters that are common sources of contention in chapter 11 cases:

- relief from the automatic stay.
- use of cash collateral.
obtaining credit.

Of these, perhaps the most interesting portions of the rule are those governing use of cash collateral. Imagine this scenario: 24 hours after the chapter 11 case begins, the debtor appears before the judge, arm in arm with the secured creditor. The debtor says he needs instant authorization to use cash collateral in order to stay in business. The secured creditor says he will consent, but only if the judge signs an order granting broad protections for his priority position, as to both pre- and post-bankruptcy claims.

The judge is necessarily in something of a bind: She can believe the sincerity of both presentations, but she is likely to worry that the debtor and secured party are acting together at the expense of unsecured creditors. Seen in this light, it is not surprising that Rule 4001 sets criteria for notice to other parties, for time limits, and (perhaps not least important) for ex parte relief under limited circumstances.

Perhaps the most common point of unfamiliarity for nonbankruptcy litigators appearing in bankruptcy court is the disposition of claims. For the moment, consider the case of the plaintiff whose defendant files for bankruptcy in the middle of the lawsuit. What happens next? The plaintiff’s first impulse will be to continue the lawsuit. But he can’t—he is barred by the automatic stay which prohibits a creditor from taking action against a debtor to collect claims. He might seek relief from the stay to continue the lawsuit, but if the debtor is deeply insolvent and will ultimately get a discharge, then continuing the lawsuit may just be throwing good money after bad.

The Bankruptcy Code and Rules contemplate something more stripped-down and simple. The creditor (plaintiff) may file a “proof of claim,” as set forth in §501 and Bankruptcy Rules 3002 and 3003, after which time the trustee or DIP may object to the claim as provided by Rule 3007. At this point, “the court, after notice and a hearing, shall determine the amount of such claim…” §502(b). But note that this brings about a contested matter, and not “adversary proceeding,” because such a proceeding is not one of those enumerated in Rule 7001.

But suppose the claim involves some more elaborate matter, such as a suit alleging patent infringement, with a prayer for damages sufficiently large that in itself it would be enough to put the debtor out of business. How will a bankruptcy forum go about resolving such a complicated matter?

One answer will shock a good many litigators, especially patent litigators. The bankruptcy judge may have the power to adjudicate the matter right there in the bankruptcy court. This assertion is bound to generate a good deal of sputtering about the role of the specialized court. But from at least one perspective, the assertion of jurisdiction is perfectly straightforward—the point of bankruptcy is to get all the issues relating to the debtor into one forum, where one judge can effect a global resolution.

Practically speaking, this result isn’t likely. Most bankruptcy judges have plenty to do without trying patent cases. A more conventional strategy would go something like this: the claimant will move for relief from the stay to continue with the lawsuit in a nonbankruptcy forum on the question of liability and damages, while stipulating that the bankruptcy court...
Chapter 5 - An Overview of Bankruptcy Litigation

Bankruptcy litigation is a complicated topic and we have just begun in this chapter to outline some of the important issues. The next few chapters will continue our discussion of the litigator in the bankruptcy forum. But we leave you with this thought: bankruptcy litigation is important and it is difficult to be a good bankruptcy lawyer if you are not a competent litigator. But chapter 11 is mostly about negotiation, rather than litigation. And many more successful reorganizations are the product of skilled negotiation than hotly contested litigation. In other words, you should know how to protect your client’s interests in the courtroom, but you may do your most important work in the hallway or the conference room.

It is the unique blend of litigation and transactional practice that makes chapter 11 practice so interesting. Some would claim that this specialized field is the last home of the generalist practitioner, as just about every industry and social issue related to business has landed in bankruptcy court, from airlines to windfarms. Potentially every nonbankruptcy law issue can arise in Chapter 11. It is where all the problems that could not be solved elsewhere come to reside. And there they are litigated, negotiated, documented, and put to rest.
APPENDIX 5(a)
FORM 16D. CAPTION FOR USE
IN ADVERSARY PROCEEDING

United States Bankruptcy Court

_________________ District Of ____________

In re ____________________________, ) ) Case No.
Debtor ) )
) )
) )
) ) Chapter _________________________

__________________________, ) )
Plaintiff ) )
) )
) )

__________________________, ) )
Defendant ) )

COMPLAINT [or other Designation]

[If in a Notice of Appeal (see Form 17) or other notice filed and served by a debtor, this caption must be altered to include the debtor’s address and Employer’s ‘Tax Identification Number(s) or last four digits of Social Security Number(s) as in Form 16A.]
INSTRUCTIONS FOR COMPLETING OFFICIAL FORM 16 D
CAPTION FOR USE IN ADVERSARY PROCEEDING OTHER THAN
FOR A COMPLAINT FILED BY A DEBTOR

I. Introduction

An adversary proceeding is the equivalent of a lawsuit within the bankruptcy case. A caption for an adversary proceeding contains both the caption for the overall bankruptcy case and an adaptation of a caption for a civil action (lawsuit) in which the parties are designated as “plaintiff” and “defendant.”

Together, the summons and complaint function as notice to the defendant of the filing of the adversary proceeding. Section 342(c) of the Bankruptcy Code requires a debtor to provide additional information on any notice sent by the debtor to a creditor. Official Form 16C, which includes this additional information, is to be used when the party filing an adversary proceeding is the debtor. Instructions for completing Official Form 16C appear following that form. This form, Official Form 16D, should be used for all other documents in an adversary proceeding, including a complaint filed by any party other than the debtor.

II. APPLICABLE LAW AND RULES


Bankruptcy Rule 7001 lists the kinds of actions for which an adversary proceeding is required. Bankruptcy Rule 7010 directs the parties to use an official form of caption in an adversary proceeding. Bankruptcy Rule 7004 requires a plaintiff to serve on each defendant a copy of the complaint along with another document called a summons.

III. DIRECTIONS

1. After the words “United States Bankruptcy Court,” the name of the federal judicial district in the which the particular bankruptcy court is located should be inserted. Some districts include an entire state, and their names should be written as follows: “District of Utah.” Other districts comprise only part of a state and should be written as follows: “Eastern District of Tennessee.”
2. Following the words “In re,” the debtor’s or the joint debtors’ names should be inserted in the space provided.

3. The debtor’s or the joint debtors’ names should be followed by the designation “Debtor.”

4. The case number should be stated in the space provided. The case number will be assigned by the clerk’s office when the petition is filed; it also appears on the “Notice of Commencement of Case. . . Meeting of Creditors, and Fixing Dates” mailed to creditors at the beginning of the case.

5. The chapter number to be inserted in the space provided is the chapter of the Bankruptcy Code under which the case is proceeding at the time the paper is filed. A bankruptcy case can be filed under one chapter, but converted to a different chapter later in the case. If a case has been converted, the court will have sent notice of that fact.

6. The name of the party filing the complaint should be inserted in the space provided, followed by the designation “Plaintiff.”

7. The name(s) of the party or parties against whom the adversary proceeding is directed should be inserted in the space provided, followed by the designation “Defendant” or “Defendants.”

8. The adversary proceeding number will be assigned by the clerk’s office by the clerk’s office when the adversary proceeding is filed.

9. The title “COMPLAINT” should appear in all capital letters. A brief description of the action being initiated by the complaint can be added. A description of a commonly filed complaint would be “COMPLAINT UNDER §523(c) OF THE BANKRUPTCY CODE TO DETERMINE THE DISCHARGEABILITY OF A DEBT.”

10. Some courts may have local requirements for additional information that must be provided as part of the caption. Some of the more frequent local requirements are to state the name of the judge to whom the case or matter is assigned and for an attorney to state the attorney’s name and state bar number or other identification number. Anyone planning to file a motion or other paper in a bankruptcy case should check with the clerk’s office at the bankruptcy court concerning local requirements.

11. Once the caption is complete, the text of the paper to be filed should begin.
Appendix 5(b) - Subpoena for Rule 2004 Examination

United States Bankruptcy Court

District Of

In re __________________________,  

Debtor

To: ____________________________

Case No1. ____________________________

Chapter ____________________________

☐ YOU ARE COMMANDED to appear and testify at an examination under Rule 2004, Fed. R. Bankr. P., at the
place, date, and time specified below. A copy of the court order authorizing the examination is attached.

PLACE OF TESTIMONY  DATE AND TIME

☐ YOU ARE COMMANDED to produce and permit inspection and copying of the following documents or
objects at the place, date, and time specified below (list documents or objects):

PLACE  DATE AND TIME

ISSUING OFFICER SIGNATURE AND TITLE  DATE AND TIME

ISSUING OFFICER’S NAME, ADDRESS AND PHONE NUMBER

1 If the bankruptcy case is pending in a district other than the district in which the subpoena is issued, state
the district under the case number.
PROOF OF SERVICE

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<th>DATE</th>
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SERVED

SERVED ON (PRINT NAME)   MANNER OF SERVICE

SERVED BY (PRINT NAME)   TITLE

DECLARATION OF SERVER

I declare under penalty of perjury under the laws of the United States of America that the foregoing information contained in the Proof of Service is true and correct.

Executed on

<table>
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Rule 45, Fed. R. Civ. P., Parts (c) & (d) made applicable in cases under the Bankruptcy Code by Rule 9016, Fed. R. Bankr. P.

c) PROTECTION OF PERSONS SUBJECT TO SUBPOENAS,

(1) A party or an attorney responsible for the issuance and service of a subpoena shall take reasonable steps to avoid imposing undue burden or expense on a person subject to that subpoena. The court, on behalf of which the subpoena was issued, shall enforce this duty and impose on the party or attorney in breach of this duty an appropriate sanction, which may include, but is not limited to, lost earnings and a reasonable attorney's fee.

(2)(A) A person commanded to produce and permit inspection and copying of designated books, papers, documents or tangible things, or inspection of premises need not appear in person at the place of production or inspection unless commanded to appear for deposition, hearing or trial.

(B) Subject to paragraph (d)(2) of this rule, a person commanded to produce and permit inspection and copying may, within 14 days after service of the subpoena or before the time specified for compliance if such time is less than 14 days after service, serve upon the party or attorney designated in the subpoena written objection to inspection or copying of any or all of the designated materials or of the premises. If objection is made, the party serving the subpoena shall not be entitled to inspect and copy the materials or inspect the premises except pursuant to an order of the court by which the subpoena was issued. If objection has been made, the party serving the subpoena may, upon notice to the person commanded to produce, move at any time for an order to compel the production. Such an order to compel production shall protect any person who is not a party or an officer of a party from significant expense resulting from the inspection and copying commanded.

(3)(A) On timely motion, the court by which a subpoena was issued shall quash or modify the subpoena if it

(i) fails to allow reasonable time for compliance;

(ii) requires a person who is not a party or an officer of a party to travel to a place more than 100 miles from the place where that person resides, is employed or regularly transacts business in person, except that, subject to provisions of clause (c)(3)(iii) of this rule, such a person may in order to attend trial be commanded to travel from any such place within the state in which the trial is held, or

(iii) requires disclosure of privileged or other protected matter and no exception or waiver applies, or

(iv) subjects a person to undue burden.

(B) If a subpoena

(i) requires disclosure of a trade secret or other confidential research, development, or commercial information, or

(ii) requires disclosure of an unretained expert's opinion or information not describing specific events or occurrences in dispute and resulting from the expert's study made not at the request of any party, or

(iii) requires a party who is not a party or an officer of a party to incur substantial expense to travel more than 100 miles to attend trial, the court may, to protect a person subject to or affected by the subpoena, quash or modify the subpoena or, if the party in whose behalf the subpoena is issued shows a substantial need for the testimony or material that cannot be otherwise met without undue hardship and assures that the person to whom the subpoena is addressed will be reasonably compensated, the court may order appearance or production only upon specified conditions.

(d) DUTIES IN RESPONDING TO SUBPOENA.

(1) A person responding to a subpoena to produce documents shall produce them as they are kept in the usual course of business or shall organize and label them to correspond with the categories in the demand.

(2) When information subject to a subpoena is withheld on a claim that it is privileged or subject to protection as trial preparation materials, the claim shall be made expressly and shall be supported by a description of the nature of the documents, communications, or things not produced that is sufficient to enable the demanding party to contest the claim.
SUBPOENA FOR RULE 2004 EXAMINATION

Purpose of the Form

This subpoena is for use in conjunction with an examination held pursuant to Fed. R. Bankr. P. 2004. It may be used to compel an entity to appear and testify and/or to produce documents or other objects for inspection and copying.

Variations of this form are used in adversary proceedings and bankruptcy cases. Form B 255 is used to compel a witness to appear and testify at a trial or deposition in an adversary proceeding. The form also can be used to command the production of documents or objects or the inspection of premises. Form B 256 is used for the same functions in a bankruptcy case.

Rule 45 of the Federal Rules of Civil Procedure, which is incorporated by Fed. R. Bankr. P. 9016, governs the use of subpoenas. The subpoena forms for use in bankruptcy cases and proceedings were revised when Rule 45 was amended extensively in 1991.

Applicable Law and Rules

1. Fed. R. Bankr. P. 2004 permits any party in a bankruptcy proceeding to obtain a court order for the examination of any entity. (A copy of the order should be attached to the subpoena.) Rule 2004(b) limits the scope of the examination to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor’s estate, or to the debtor’s right to a discharge. In a family farmer’s debt adjustment case under chapter 12, an individual’s debt adjustment case under chapter 13, or a reorganization case under chapter 11 . . . the examination may also relate to the operation of any business and the desirability of its continuance, the source of any money or property acquired or to be acquired by the debtor for purposes of consummating a plan and the consideration given or offered therefor, and any other matter relevant to the case or the formulation of a plan.

2. Rule 2004(c) provides that “the attendance of an entity for examination and the production of documentary evidence may be compelled in the manner provided in Rule 9016 for the attendance of witnesses at a hearing or trial.”

3. Rule 2004(d) provides that “the court may for cause shown and on terms as it may impose order the debtor to be examined under this rule at any time or place it designates, whether within or without the district wherein the case is pending.”

4. “Subdivision (d) [of Rule 2004] applies only to the debtor and a subpoena need not be issued. There are no territorial limits on the service of an order on the debtor.” 1983 Advisory Committee Note.
B 254
continued


6. A subpoena commanding attendance at a trial or hearing shall issue from the court for the district in which the trial or hearing is to be held. A subpoena for attendance at a deposition shall issue from the court for the district designated by the notice of deposition as the district in which the deposition is being taken. If separate from a subpoena commanding the attendance of a person, a subpoena for production or inspection shall issue from the court for the district in which the production or inspection is to be made. Rule 45(a)(2).

7. At the request of a party, the clerk shall issue a subpoena for a trial, hearing, or deposition. Rule 45(a)(3).

8. As an officer of the court, an attorney may issue and sign a subpoena on behalf of a court in which the attorney is authorized to practice. An attorney also can issue a subpoena on behalf of a court for a district in which a deposition or production is compelled by the subpoena, if the deposition or production pertains to an action pending in a court in which the attorney is authorized to practice. Rule 45(a)(3).

9. A party or attorney responsible for the issuance and service of a subpoena shall take reasonable steps to avoid imposing undue burden or expense on a person subject to the subpoena. Rule 45(c)(1). The court on behalf of which the subpoena was issued shall enforce this duty and impose an appropriate sanction upon a party or attorney in breach of the duty.

10. In addition to compelling testimony, a subpoena can require the person to whom it is directed “to produce and permit inspection and copying of designated books, documents or tangible things in the possession, custody or control of that person ... at a time and place therein specified.” Rule 45(a)(1)(C).

11. A subpoena for production of evidence may be joined with a subpoena to appear at trial or hearing, or may be issued separately. Rule 45(a). If issued separately, a subpoena for production shall issue from the court for the district in which the production is to be made. Rule 45(a)(2).

12. A person commanded to produce documents or objects need not appear in person at the time of production unless commanded to appear and testify. Rule 45(c)(2)(A).

13. A subpoena may require a person who is not a party or an officer of a party to travel to an examination up to 100 miles from the place where that person resides, is employed, or regularly transacts business in person, or, subject to certain restrictions, to travel from anyplace within the state. Rule 45(c)(3)(A)(ii).
14. If a person who is not a party or an officer of a party resides beyond the geographic limits of the subpoena, the order for the Rule 2004 examination may be entered by the court where the case is pending, certified by that court, and then filed in the district where the person resides. Then the subpoena is issued in the name of the latter court and the examination is held in the district where the person resides. In re Texas International Co., 97 B.R. 582 (Bankr. C.D. Calif. 1989).

15. A subpoena may be served by any person who is not a party and is not less than 18 years of age. Rule 45(b)(1).

16. Service of a subpoena upon a person named therein is made by delivering a copy of the subpoena to the person and, if the person’s attendance is commanded, by tendering to that person the fees for one day’s attendance and the mileage allowed by law. When the subpoena is issued on behalf of the United States or an officer or agency thereof, fees and mileage need not be tendered. Rule 45(b)(1).

17. An entity other than the debtor shall not be required to attend a Rule 2004 examination unless the mileage and one day’s witness fee are tendered first. Rule 2004(e). If the witness to be examined is the debtor, no fees need be tendered, unless the deposition is to be taken more than 100 miles from the debtor’s residence. If the debtor lives more than 100 miles away, the debtor shall be tendered mileage for the excess of 100 miles. Rule 2004(e).

18. Computation of the fees and allowances to be paid a witness for attending a Rule 2004 examination is governed by 28 U.S.C. § 1821.

19. As of July 1, 1999, the witness fee was $40 per day, 28 U.S.C. § 1821(b), and the mileage allowance for an automobile was 31 cents per mile, 41 C.F.R. § 301-10.303. Computation of the mileage allowance is set by a uniform table maintained by the General Services Administration. 28 U.S.C. § 1821(c)(2).

20. Subject to the restrictions in Rule 45(c)(3)(A)(ii), a subpoena may be served at any place within the district of the court by which it is issued, at any place without the district that is within 100 miles of the place of examination, or at any place within the state where a state statute or court rule permits service of a subpoena issued by a state court of general jurisdiction sitting at the place of the examination. In addition, when provided by a federal statute, the court may, for cause, authorize the service of a subpoena at any other place. Rule 45(b)(2).

22. “Proof of service when necessary shall be made by filing with the clerk of the court by which the subpoena is issued a statement of the date and manner of service and of the names of the persons served, certified by the person who made the service.” Rule 45(b)(3).

23. The duties of a person responding to a subpoena are set out in Rule 45(d). In particular, the rule provides that documents shall be produced as they are kept in the usual course of business or the records may be organized and labeled to correspond with the categories set out in the subpoena.

24. Rule 45(e) provides that failure to obey a subpoena without adequate excuse may be deemed a contempt of court.

Instructions for Subpoena

Caption
1. Identify the judicial district in which the bankruptcy case was filed. Example: “Eastern District of California.”
2. “In re”: Insert the name of the debtor as it appears in the bankruptcy petition.
3. “Case No.”: Insert the bankruptcy case number assigned by the court when the case was filed.
4. “Chapter”: Insert the chapter of the Bankruptcy Code under which the case is pending.

To
Insert in this box the complete name and address of the witness to be examined. (The clerk may issue a subpoena, signed but otherwise in blank, but the form must be filled in, including the name and address, before the subpoena is served.)

Check boxes
Check the appropriate box or boxes.

Place
Insert in this box the complete address of the place where the witness is to appear and be examined. The address should include the name of the building, the room number, street number and name, city, state, and zip code.
Appendix 5(b) - Subpoena for Rule 2004 Examination

Date and Time

Insert in this box the date and time of the Rule 2004 examination.

You Are Commanded to Produce

Insert in this box the exact description of any and all documents and objects the witness is required to produce. If no documents and objects are required, enter “NONE” in this box.

Place

Insert in this box the complete address of the place where the witness is to produce the documents and objects. The address should include the name of the building, the room number, street number and name, city, state, and zip code. If no documents and objects are required, enter “Not Applicable” in this box.

Date and Time

Insert in this box the date and time at which the witness is to produce the documents and objects. If no documents and objects are required, enter “Not Applicable” in this box.

Issuing Officer Signature and Title

The person who issues the subpoena signs here, states his or her title (for example, “deputy clerk” or “attorney”), and dates the signature.

Issuing Officer’s Name and, Address and Phone Number

If an attorney issues the subpoena, insert the attorney’s name, street address, city, state, zip code and telephone number, including area code, in this box. If the subpoena is issued by the clerk, insert the information for the clerk’s office.

Instructions for Proof of Service

The proof of service and declaration on the reverse of the form are to be completed, under penalty of perjury, by the person who serves the subpoena.

Served

Insert the date and place the subpoena was served. Specify the street address, city, state, and zip code of the place service of the subpoena was made.
B 254
continued

**Served On**
Insert the full (printed or typed) name of the person who received the subpoena.

**Manner of Service**
Describe the manner of service.

**Served By**
Insert the full (printed or typed) name of the person who served the subpoena and specify the person’s title.

**Declaration of Server**
The declaration is to be completed as follows

Date: - Insert on this line the month, day and year the certificate is signed.

Signature of Server: - The person who served the subpoena must sign. This must be an ORIGINAL signature.

Address of Server: - **Print or type** the address of the person who signs the declaration.

**Protection of Persons Subject to Subpoenas**
In order to protect persons subject to subpoenas, Rule 45(a)(1)(D) requires that every subpoena set forth the text of subdivisions (c) and (d) of the rule. Furthermore, the rule provides that a party or attorney responsible for the issuance and service of a subpoena shall take reasonable steps to avoid imposing undue burden or expense on a person subject to the subpoena and that the court on behalf of which the subpoena was issued shall enforce this duty. Rule 45(c)(1).

**General Information for the Clerk**
Fed. R. Bankr. P. 2004 permits any party in a bankruptcy proceeding to obtain a court order for the examination of any entity, subject to certain limitations. Form B 254, Subpoena for Rule 2004 Examination, is used to compel an entity to appear and testify at an examination. The subpoena also can be used to require the entity to produce documents or other objects.

Fed. R. Civ. P. 45, which is incorporated by reference by Fed. R. Bankr. P. 9016, authorizes both the clerk and attorneys to issue subpoenas. In many cases the clerk will issue subpoenas in blank. The name of the party to be served need not be filled in when the clerk issues a subpoena, but the subpoena must be completed before it is served.
If the person to be examined resides outside of the district where the bankruptcy case is pending or if the production is to take place in another district, the subpoena for the Rule 2004 examination may be issued in the name of the bankruptcy court where the examination or production is to take place. Rule 45(a)(2). When a clerk issues a subpoena for an examination or production in a case which is pending in another district, the clerk in the second district should create a special file for noting the issuance of the subpoena and filing the related papers, including a certified copy of the order for the Rule 2004 examination issued by the court where the case is pending.
Chapter 6
Overview of Avoidance Actions

The way to understand a chapter 11 DIP’s avoiding powers is to recognize that the
debtor wears two hats.

For the first hat, think the Lone Ranger, or at least Burl Ives in East of Eden. He’s the
stranger who comes in on the game and scoops all the money off the table to distribute it in an
equitable manner.

For the second hat, think Hagar the Horrible, with helmet and horns. Under this hat, he is
the representative of creditors and can do things that the debtor cannot do.

To grasp this point, recall the history of bankruptcy law: in the beginning, bankruptcy
was a kind of proto-class-action, where creditors clubbed together to collect their debts. They
selected the trustee; he was, in a sense, their agent. Not surprising, therefore, that he could do
tings they could do. Specifically, he gets to set aside, unravel, treat as a nullity -- or in the
jargon of bankruptcy law “avoid” certain transactions that the debtor engaged in before
bankruptcy.

These transactions are often perfectly valid as between debtor and transferee. But they
won’t be binding on creditors -- and the trustee (in his Hagar headgear) is the creditors’ voice.

The Supreme Court got this point interestingly wrong in a case decided a century ago,
just after the beginning of our modern bankruptcy law. The case is York Manufacturing Co. v.
Cassell, 201 S. Ct. 344 (1906). A creditor held a conditional sales contract that was valid against
the debtor but not filed in the public records and so invalid against creditors. The Supreme Court
held that the trustee stepped into the shoes of the debtor and took the property of the debtor
subject to any encumbrances that would have been binding on the debtor.

The Court thus got the Lone Ranger point but missed the Hagar point altogether. Congress responded quickly with amendments giving the trustee the powers of a lien creditor
and a judgment creditor. The legislative history made it clear that Congress intended to overrule
York, but in a broader sense, you might say it was merely reestablishing the traditional view that
the trustee (or DIP, acting as trustee) has powers, exercisable for the benefit of creditors, that go
beyond those rights that the pre-petition debtor would have.

In our current Bankruptcy Code, we have half a dozen or more “avoiding powers,” most
of which are the progeny of this overruling amendment. Each of these avoiding powers is
codified in chapter 5 of the Bankruptcy Code. Explaining the various avoiding powers is easiest
by illustration.
Hypothetical Lien Creditor and BFP Rights

Start with the most intelligible case. Fredco borrows $10 million from Barney Bank and gives it a security interest in its Dinobarn, previously owned by Fredco free and clear.

In addition to the security agreement signed by Fredco granting Barney Bank a security interest in Dinobarn, it also signs a financing statement or UCC-1. However, Barney Bank forgets to file the financing statement in the public records. Another creditor, Gazoo Corp., who does not hold a security interest, gets a judgment against Fredco and sends the sheriff out to levy on Dinobarn. As between Barney Bank and Gazoo Corp., who wins?

The answer is Gazoo Corp. The Uniform Commercial Code says (with Byzantine indirectness) that an unperfected security interest is subordinate to the rights of a lien creditor. On levy, Gazoo Corp. becomes a lien creditor. Barney Bank’s financing statement remains unfiled, therefore unperfected, so Gazoo Corp. prevails.

So much for state law. What of bankruptcy? The answer is in §544(a)(1), which provides that the DIP has the rights of a lien creditor. Fredco goes into bankruptcy owing Barney Bank, Gazoo Corp. and others: Barney Bank has a security interest, but unfiled; Gazoo Corp. has a claim, but not a lien. If Gazoo Corp. had got a lien at state law before Barney Bank filed, then Barney Bank’s security interest would have been subordinate to Gazoo Corp.’s claim.

So, per §544(a)(1), Barney Bank’s security interest is subordinate to the rights of the trustee. Barney Bank retains its claim, but loses its security interest: it has to go to the back of the queue and share with the other unsecured creditors (including Gazoo Corp.), pro rata.

Actually, the provision is even more powerful than we have seen so far. Based on what we have seen, we can say that the DIP “steps into the shoes” of Gazoo Corp. But the section provides that the trustee gets this right “whether or not such a creditor exists.” In other words, if a creditor could have trumped Barney Bank on the petition date, then the trustee can trump Barney Bank. As a practical matter, this may not seem to amount to much: at least in our example, there virtually always will be a creditor with the right to trump Barney Bank. But the practical point is that the DIP doesn’t have to prove it; he can operate on the rule of “as if.”

So far, this sounds like “classic bankruptcy” -- trustee as a kind of “class representative” doing what a creditor could do. But go back and tweak our first example. Suppose that Fredco gave Barney Bank a security interest in -- not Dinobarn, but in Blackacre, a parcel of real estate. Note that the Uniform Commercial Code no longer governs. We are in the realm of real estate law. Suppose as before that Fredco signs, but that Barney Bank neglects to record, a mortgage. Fredco does not pay. As between Barney Bank and Gazoo Corp., who gets first dibs on Blackacre?

You might think that the answer would be the same as before, and in some states, indeed it is. But in many states, real estate priority rules differ from the rules under the UCC. Many states say that the unrecorded mortgage is void against “a bona fide purchaser,” or words to that effect. However, quite a few cases hold that a “lien creditor” is not a “bona fide purchaser.” So if Gazoo Corp. is a (mere) lien creditor, it may lose the priority conflict with an unrecorded
This rule may or may not make sense but that is beside the point. The point -- in bankruptcy -- is this: if Fredco goes into bankruptcy and the trustee had nothing but the “lien creditor” power of §544(a)(1), then Barney Bank’s mortgage retains its priority, even though unrecorded. Another avoiding power, however, provides that the trustee has the rights of “a bona fide purchaser,” and thus the trustee can avoid the unrecorded mortgage on real property just as he can set aside the unperfected security interest in personal property.

**Fraudulent Transfers**

Under nonbankruptcy fraudulent transfer law, a creditor may avoid a transaction between the debtor and a third party if the transaction is, on appropriate standards, adverse to the creditor. Bankruptcy law “annexes” fraudulent transfer laws in two interesting ways.

First, §544(b) provides that the DIP may avoid a transfer that is “voidable by a creditor” at state law. This rule is both broader and narrower than the rule under §544(a), which we examined above. It is broader in that it grants to the trustee rights of “creditors” without qualification -- not just the narrower class of “lien creditors,” as in §544(a). It is narrower in that, to use the power, the DIP has to prove the existence of an actual creditor by whom the transfer might have been avoidable. This is not trivial: if the trustee fails to prove the existence of such a creditor, he loses. There are plenty of cases where the DIP has identified what looks like a promising fraudulent transfer avoidance action, only to lose it because it couldn’t make the link to an actual creditor offended at state law.

Second, §548 is a fraudulent transfer provision in its own right, giving the DIP the authority to avoid fraudulent transfers without having to rely on §544(b)’s incorporation of state law. Under §548(a)(1)(A), the DIP may avoid a transfer that was made with the actual intent to “hinder, delay or defraud” a creditor -- call it an “actual fraud” fraudulent transfer. Under §548(a)(1)(B), the DIP may avoid a transfer made for “less than a reasonably equivalent value,” sometimes referred to as “constructive fraud.” If the DIP is relying on this constructive fraud premise, then he must also show one of four additional facts. That is (somewhat simplified), he must show that the debtor was either:

- insolvent at the time of the transfer, or rendered insolvent thereby;
- engaged in a business or transaction for which his remaining property was “unreasonably small capital;”
- intending to incur debts beyond his capacity to repay; or
- made the transfer or incurred the obligation for the benefit of an insider under an employment contract and out of the ordinary course of business.
The critical distinction here is the matter of intent. If the DIP can show the relevant intent, then it doesn’t have to worry about issues of solvency or value. If it has the right evidence on value and solvency, it doesn’t have to worry about intent.

Bankruptcy Code §548 parallels, and in many respects, duplicates state law as codified via the Uniform Fraudulent Transfer Act. So the question arises, given §548, is there any reason for §544(b)? The answer is “yes.” There are at least two reasons.

One, §544(b) may pick up some fraudulent transfers that §548 misses. For example, under §548, the trustee can reach back to undo transactions made only within two years before bankruptcy. The state law reach-back period is longer—typically 3 to 5 years. And two, §544(b) gives the DIP the power to avoid any transaction that is voidable under state law—i.e., not just fraudulent transfer laws. State law may present opportunities for avoidance aside from fraudulent transfer law. For example, a few states retain so-called “bulk transfer” statutes, permitting an aggrieved creditor to avoid bulk transfers of inventory. In the appropriate case, this right, too, will pass to the trustee.

Preferences

All the rights we have examined so far are predicated more or less on nonbankruptcy law. There is one important avoidance power that exists independent of nonbankruptcy law. This is the power to avoid preferences under §547.

To understand preferences, it is easier to understand what they are not. Consider the case of Delbert, who owes $100 each to Butcher, Baker and Candlestick Maker, all unsecured. Delbert pays $100 in cash to Butcher and then files for bankruptcy, holding no other assets. Baker and Candlestick Maker have claims against the estate of Delbert, but the claims are worthless. Butcher has no claim because he was paid in full. The first thing to note about this case is that Delbert’s conduct is not “wrong” in any global sense, because it is not wrong to pay a debt.

The trouble is that a first principle of bankruptcy law is that similarly situated creditors share pro rata. If you allow the debtor to pick and choose which creditors it pays on the eve of bankruptcy, then you undercut this first principle. So it is not surprising to find in the Bankruptcy Code a rule that allows the trustee to undo certain pre-bankruptcy transactions, otherwise unobjectionable, that would have the effect of undercutting the principle of pro rata distribution.

The core of preference law is in §547. The prima facie case is in §547(b). It provides (slightly simplified):

The DIP may avoid a transfer:

- to a creditor;
- for an antecedent debt (a debt that existed before the transfer);
- made while the debtor was insolvent;
and within 90 days before bankruptcy (or 1 year if the recipient is an insider);

- if it permits the creditor to get more than it would get in Chapter 7.

So in our example, Delbert is clearly insolvent: he has $100 and owes $300. If the transfer had not occurred then creditors would have taken \( \left( \frac{1}{3} \right) \times 100 = 33.33 \) each (ignoring costs), so Butcher clearly got more via the transaction than he would have under Chapter 7. The only open question is timing: if the transaction was made within 90 days before bankruptcy, then it would appear to be avoidable. If it was made earlier—say, 91 days before bankruptcy—then it would seem to be bulletproof.

Most preferences involve payment of money to satisfy a debt, but there is one other case that is important but perhaps not so obvious. That is: suppose that Delbert, rather than paying Butcher, merely gave him a security interest in all his property to secure his antecedent debt, and that Butcher perfected that security interest within 90 days of bankruptcy. Assuming the other conditions are met, then this giving of security may also be a preference and avoidable under §547.

The *prima facie* elements of a preference are not, however, the end of the story. There are many cases where the debtor made a payment that meets the elements of a preference, but will not be avoidable because it falls within one of the defenses set forth in §547(c).

The most common of these is probably the “ordinary course of business” defense which exempts from preference recovery payments made in the ordinary course of business between the debtor and the recipient or on customary terms. See §547(c)(2). A second common defense is “subsequent new value” which exempts a payment from avoidance to the extent that, after receiving the payment, the recipient gives some additional value (say, ships new goods) to the debtor. See §547(c)(4). This defense essentially allows the creditor to offset the value it gave to the debtor after receiving a preferential payment against its preference liability. In 2005, BAPCPA added a safe harbor defense for transferees of a business debtor who receive less than $5,000 during the preference period in order to address what was perceived as abusive bulk preference filings against all of a debtor’s 90-day payees that creditors would default in or settle to save the cost of defense of the action. See §547(c)(9). There are many other defenses, and one of the first tasks of a lawyer defending a preference action is to go through the list in §547(c) to see which defenses might apply. We discuss these matters in more detail in the next chapter.
APPENDIX 6(a)
IN RE: ICARUS HOLDINGS, LLC

The following edited order illustrates the operation of the trustee’s general avoidance powers in the context of alter ego recovery.

PIEDMONT HARDWOOD FLOORING, INC. v. THOMPSON LAND AND TIMBER COMPANY, LLC (IN RE: ICARUS HOLDINGS, LLC)

UNITED STATES BANKRUPTCY COURT
FOR THE MIDDLE DISTRICT OF GEORGIA, MACON DIVISION


This matter comes before the Court on Plaintiff Bert F. Thompson’s Complaint for Injunctive Relief and on Plaintiff Edwards Wood Products, Inc.’s Complaint for Damages. Both proceedings have raised the issue of who may sue the principal of a debtor in possession under an alter ego theory. This is a core matter within the meaning of 28 U.S.C. §157(b)(2)(O). After considering the pleadings, the evidence, the briefs, and the applicable authorities, the Court enters the following decision in conformance with Federal Rule of Bankruptcy Procedure 7052.

I. Undisputed Facts

For purposes of this Opinion, the Court has consolidated two cases with identical facts that raise the same determinative issue. The only material difference between the two cases is their procedural posture. In the case of Edwards Wood Products, Inc., the creditor filed an alter ego suit against Bert F. Thompson, principal of Icarus Holdings, LLC (“Debtor,” “Debtor-in Possession,” or “DIP”), in state court, the suit was removed to this Court, and Edwards now seeks to remand the suit (the “Edwards case”). In the case of Baillie Lumber Company, LP, Thompson is seeking an injunction to prevent Baillie from proceeding with a similar alter ego suit it filed against him in state court (the “Baillie case”). Debtor has intervened in both cases.

The Court asked the parties to file cross motions for summary judgment on the issue of whether or not an alter ego claim against the principal of a corporate debtor is property of the estate and, thus, can be brought only by the trustee or DIP. The statements of undisputed material facts submitted with the motions were indistinguishable and provide as follows:

Debtor operated as a national manufacturer and distributor of a variety of unfinished solid hardwood flooring, primarily for residential use. Prior to Debtor’s bankruptcy filing, Edwards and Baillie (the “Creditors”) sold lumber to Debtor for which Debtor has not paid.

Also prior to the filing, Debtor’s principal member and former president and manager, Thompson, engaged in certain alleged financial irregularities that adversely impacted Debtor’s liquidity. These irregularities included allegedly using Debtor’s assets and resources, including Debtor’s employees and equipment, to subsidize the construction and improvement of Thompson’s hunting lodge in Camden County, Georgia. Additionally, Thompson used Debtor’s
assets to fund the operation of Southern Wood Services, LLC, a separate and affiliated company also owned by Thompson. Thompson no longer is involved in the management of Debtor.


Because the rights, powers, and duties of a debtor in possession are essentially the same as those of a trustee pursuant to 11 U.S.C. §1107, the terms “trustee” and “debtor in possession” are used interchangeably throughout this Opinion.

On Dec. 28, 2001, Debtor filed an adversary proceeding in this Court against Thompson and against Thompson Land and Timber, LLC, a company partially owned by Thompson. The complaint asserts, among other things, that Thompson’s financial irregularities and prepetition transfers were fraudulent transfers and that the entities, including Thompson, holding the transferred property do so in constructive trust for Debtor. The adversary proceeding was filed for the primary purpose of filing a lis pendens on the Camden County property. Debtor did not specifically allege an alter ego or piercing the corporate veil cause of action against Thompson or Thompson Land and Timber in the complaint.

On Jan. 11, 2002, the office of the United States Trustee for the Middle District of Georgia, Macon Division, appointed the Official Committee of Unsecured Creditors (the “Committee”). Edwards and Baillie are both members of the Committee.

Since the petition date, the Committee, Debtor, and Thompson have engaged in settlement negotiations. While a binding settlement agreement has not been executed, the Committee, Debtor, and Thompson have agreed orally to settle various disputes, including Debtor’s adversary proceeding against Thompson and any alter ego claims that Debtor or the Committee may be entitled to assert against Thompson. The proposed settlement agreement provides that in settlement of all claims against Thompson, he shall pay to Debtor’s estate $900,000 if paid on or before Feb. 15, 2003, or $950,000 if paid after Feb. 15, 2003, and that Thompson shall remain liable on a personal guaranty of a debt not to exceed $1,247,000 owed by Southern Wood Services to Debtor’s estate.

In January 2002, Thompson Land and Timber sold the Camden County property, and net proceeds of approximately $540,000 were paid into the registry of the Court. Under the terms of the proposed settlement agreement, this $540,000 will be paid to Debtor’s estate upon approval of the settlement by the Court and will be applied to reduce Thompson’s obligations under the proposed settlement agreement.

On Jan. 8, 2002, Baillie filed suit against Thompson, individually, in the State Court of Bibb County, Georgia, alleging, among other things, that Thompson is the alter ego of Debtor and, therefore, is personally liable for Debtor’s debts, including any indebtedness owed by Debtor to Baillie. On April 17, 2002, Thompson filed a Complaint for Injunctive Relief against Baillie in this Court. The complaint asserts that Baillie’s alter ego claim against Thompson is property of Debtor’s bankruptcy estate. It also alleges that, to the extent Baillie is successful in
its state court action, Thompson will be unable to satisfy his obligations under the proposed settlement agreement.

On April 3, 2002, Edwards filed suit against Thompson, Southern Wood Services, and Thompson Land and Timber in Bibb County Superior Court. The complaint alleges, among other things, that as the alter ego of Debtor, Thompson is personally liable for Debtor’s debts, including any indebtedness owed by Debtor to Edwards. Additionally, the complaint alleges that Southern Wood Services is the alter ego of Debtor and, therefore, is liable for Debtor’s debts, including any indebtedness owed by Debtor to Edwards. The complaint also included an allegation that property held by Thompson Land and Timber was held in constructive trust for the benefit of Edwards. The defendants in the state court action answered, denying that Edwards was entitled to the relief requested. On May 1, 2002, the defendants removed the state court action to this Court. Edwards has filed a motion to remand the case to state court.

Thompson, Debtor, the Committee¹, Southern Wood Services, and Thompson Land and Timber contend that the alter ego claim against Thompson is property of the bankruptcy estate; thus, only Debtor in Possession has standing to bring an alter ego claim. Baillie and Edwards contend that their state court claims are not property of Debtor’s estate and that they are not attempting to recover property of or money owed to the estate, so that neither Debtor nor the Creditor’s Committee has the authority to settle their state court claims.

II. Conclusions of Law

Summary judgment is governed by Federal Rule of Civil Procedure 56, made applicable to bankruptcy through Bankruptcy Rule of Procedure 7056. Under Rule 56, a party is entitled to summary judgment when the “pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.” Fed. R. Civ. P. 56(c). The parties in this case concede that no material facts are in dispute. The Court agrees. Thus, the Court may proceed to the legal question.

The issue before the Court is whether or not a suit to pierce the corporate veil under an alter ego theory is property of a corporate debtor’s bankruptcy estate subject to the exclusive control of the trustee. The Creditors argue that a trustee can only sue to recover money owed to the estate; it cannot sue to recover debts owed to individual creditors. Thompson and Debtor argue that the alter ego claim is property of the estate, and the trustee has exclusive standing to pursue such a claim if (1) under Georgia law Debtor could have asserted an alter ego claim to pierce its own veil, and (2) the claim is a general one that could have been brought by any creditor. Thompson and Debtor further contend that the trustee has standing to pursue alter ego claims under §544 ² of the Bankruptcy Code. In the alternative, Thompson and Debtor argue that

¹ The Committee filed an amicus curiae brief in the Baillie case.

² Section 544 allows the trustee to step into the shoes of a creditor to avoid certain transfers. 11 U.S.C.A. §544 (West 1993 & Supp. 2002).
the Court may use its §105(a)\(^3\) power to enjoin the Creditors from prosecuting alter ego actions against Thompson.

The Court holds that under Georgia law, the alter ego claim asserted by the Creditors is property of the estate that Debtor in Possession has exclusive standing to pursue.

All parties correctly assert that this question is answered by reference to state law regarding who can bring an alter ego claim. Section 541 of the Bankruptcy Code defines property of the estate to include “all legal or equitable interests of the debtor in property as of the commencement of the case.” 11 U.S.C.A. §541(a)(1) (West 1993). This includes causes of action. Whether or not an interest falls within the scope of §541 is a federal question answered by reference to the relevant nonbankruptcy law.

Several circuit courts have considered whether an alter ego claim is property of the estate and have reached different results due to variations in state law. However, the courts’ reasoning begins with the same premise: If the debtor could have brought the suit outside of bankruptcy then the claim becomes property of the estate assertable by the trustee.

For example, in *Mixon v. Anderson (In re Ozark Restaurant Equipment Co., Inc.),* 816 F.2d 1222 (8th Cir. 1987), a Chapter 7 case involving an Arkansas corporation, the trustee brought an alter ego action on behalf of the creditors. *Id.* at 1223. The court held that the trustee had no standing to bring the suit because it was not an interest of the debtor. *Id.* at 1225-26. The court agreed that “whenever a cause of action ‘belongs’ to the debtor corporation, the trustee has the authority to pursue it in bankruptcy proceedings.” *Id.* at 1225. However, Arkansas law requires that a third party be harmed by disregard of the corporate form. *Id.* Because of this third party requirement, the court concluded that under Arkansas law, a corporation could not pierce its own veil. *Id.* Thus, the alter ego claim did not become property of the estate assertable by the trustee. \(^4\) *Id.* at 1226. However, the court acknowledged that in other states, the law could allow a corporation to pierce its own veil. *Id.* n.7.

The court reached a different result by following similar reasoning in *S.I. Acquisition, Inc. v. Eastway Delivery Service, Inc. (Matter of S.I. Acquisition, Inc.),* 817 F.2d 1142 (5th Cir. 1987). The creditor filed an alter ego suit against the principal of the debtor. After the debtor filed a Chapter 11 petition, it claimed that the creditor’s suit violated the automatic stay, even though the debtor had been severed from the case and was not a party to the suit. *Id.* at 1144-45. The court found that under Texas law a corporation could pierce its own corporate veil because

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\(^3\) “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” 11 U.S.C.A. §105(a) (West 1993).

\(^4\) See also *Spartan Tube & Steel, Inc. v. Himmelspach (In re RCS Eng’d Prods. Co., Inc.),* 102 F.3d 223, 227 (6th Cir. 1996) (“Since a subsidiary may not bring an alter ego claim against its parent company under Michigan law, the claim does not become the property of the [subsidiary’s bankruptcy] estate...”). Compare *Williams v. California 1st Bank,* 859 F.2d 664, 667 (9th Cir. 1988) (denying the trustee standing to pursue a securities fraud action on behalf of creditors, in part, because the debtor “has no claim of its own that it could press against the defendant.”).
“the predominate policy of Texas alter ego law is that the control entity that has misused the corporation form will be held accountable for the corporation’s obligations.” *Id.* at 1152. As a result, the court concluded that the alter ego action was property of the estate, and any such suits by creditors ran afoul of the automatic stay.\(^5\) *Id.* at 1153. In addition, the court noted that its decision furthered a policy underlying the Bankruptcy Code because, if the creditor’s alter ego action were not stayed, it would “promote the first-come-first-served unequal distribution dilemma that the Bankruptcy Code…sought to prevent.” *Id.* at 1153-54.

The Eleventh Circuit Court of Appeals has applied similar reasoning in *E.F. Hutton & Co., Inc. v. Hadley*, 901 F.2d 979 (11th Cir. 1990). Although Hutton did not deal with veil piercing, it did question whether the bankruptcy trustee could assert causes of action held by creditors. The debtor was a dealer in mortgage securities, which it purchased through a margin account at E.F. Hutton. In the event the balance on the margin account remained unpaid, E.F. Hutton was contractually authorized to sell the securities purchased on margin and to apply the proceeds to the balance. The debtor engaged in a scheme in which it bought securities for its customers through its margin account, but rather than applying the money paid by the customers to its margin balance, the debtor diverted the funds to other purposes. Because of the resulting unpaid balance on the margin account, E.F. Hutton sold the securities for which the debtor’s customers had paid in full. After the debtor filed for bankruptcy, the bankruptcy trustee sued E.F. Hutton for, among other things, conversion of the securities. E.F. Hutton argued that the trustee had no standing to sue because the debtor did not have a property right in the securities. *Id.* at 980-81.

The Eleventh Circuit agreed with E.F. Hutton, finding that the debtor had no interest in the securities. *Id.* at 985. There was no evidence the securities were owned by the debtor rather than its customers. *Id.* Thus, the debtor’s customers—not the debtor—had a cause of action against E.F. Hutton, so that it had not become property of the bankruptcy estate. *Id.* The Hutton decision is consistent with the outcome of alter ego cases in other circuits: If the debtor could not bring a cause of action outside bankruptcy, the trustee cannot pursue that action in bankruptcy.

In reaching its decision, the Eleventh Circuit considered the United States Supreme Court case *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 92 S. Ct. 1678, 32 L. Ed. 2d 195 (1972). In Caplin, the misconduct of a third party (the indenture trustee) injured the debtor’s debenture holders. The bankruptcy trustee sought to assert a cause of action against the debenture trustee on behalf of the debenture holders. *Id.* at 418-20; 92 S. Ct. at 1680-81. The

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\(^5\) See also *Phar-Mor, Inc. v. Coopers & Lybrand*, 22 F.3d 1228, 1240 n.20 (3d Cir. 1994) (“It may seem strange to allow a corporation to pierce its own veil…In some states, however, piercing the corporate veil and alter ego actions are allowed to prevent unjust or inequitable results; they are not based solely on a policy of protecting creditors.”); *Kalb, Voorhis & Co. v. American Fin. Corp.*, 8 F.3d 130, 132 (2d Cir. 1993) (“If under governing state law the debtor could have asserted an alter ego claim to pierce its own corporate veil, that claim constitutes property of the bankrupt [sic] estate and can only be asserted by the trustee or the debtor-in-possession.”); *Steyr-Daimler-Puch of Am. Corp. v. Pappas*, 852 F.2d 132, 135 (4th Cir. 1988) (“An alter ego claim, under Virginia law, is property of the corporation so that it becomes property of the bankruptcy estate over which the trustee has control…”); *Koch Refining v. Farmers Union Cent. Exch., Inc.*, 831 F.2d 1339, 1346 (7th Cir. 1987) (“Under Illinois and Indiana law as well, a bankruptcy trustee can bring an alter ego claim of action.”).
Appendix 6(a) - In Re Icarus Holdings, LLC

Chapter 11-101

Court denied the trustee standing to sue based on three factors: (1) nothing in the Bankruptcy Act or other relevant law gave the trustee standing to sue third parties on behalf of the debenture holders; (2) the debtor had no claim against the indenture trustee; and (3) the trustee’s suit and subsequent actions initiated by the debenture holders could lead to inconsistent results. Id. at 428-34; 92 S. Ct. at 1685-88.

In Hutton, the Eleventh Circuit found all three factors to be present. 901 F.2d at 986. However, when the cause of action is property of the bankruptcy estate, these problems disappear. First, the trustee would not be suing on behalf of creditors, but on behalf of the debtor. Second, the cause of action could only become property of the estate if the debtor had a claim against the defendant. Third, because creditors would be enjoined by the automatic stay from interfering with property of the estate, they would not be able to pursue the same claim; thus, preventing inconsistent litigation results.

As the foregoing cases indicate, the Court must determine whether a corporation could bring an alter ego action against its principal under Georgia law. None of the parties were able to locate any Georgia cases directly on point, and the Court’s research has been similarly fruitless. However, it is well established that, in Georgia, in order to disregard the corporate entity because a corporation is a mere alter ego or business conduit of a person, it should have been used as a subterfuge so that to observe it would work an injustice. To prevail based on this theory, it is necessary to show that the shareholders disregarded the corporate entity and made it a mere instrumentality for the transaction of their own affairs; that there is such unity of interest and ownership that the separate personalities of the corporation and the owners no longer exist. The concept of piercing the corporate veil is applied in Georgia to remedy injustices which arise where a party has over extended his privilege in the use of a corporate entity in order to defeat justice, perpetuate fraud or to evade contractual or tort responsibility. Heyde v. Xtraman, Inc., 199 Ga. App. 303, 306, 404 S.E.2d 607, 610 (1991) (citations and internal quotation marks omitted).

Thus, the law appears to hinge on the types of equitable concerns that affected the outcome in the S.I. Acquisition, Koch Refining, Phar-Mor, American Financial and Steyr-Daimler-Puch cases. So, a cause of action invoking the alter ego theory likely would become property of the debtor’s bankruptcy estate. Moore v. Kumer (In re Adam Furniture Ind., Inc.), 191 B.R. 249, 257 (Bankr. S.D. Ga. 1996) (“Georgia law supports an alter ego action by the debtor, and...the trustee succeeds to the right to institute such an action...”); Stamps v. Knobloch (In re City Communications, Ltd.), 105 B.R. 1018, 1022 (Bankr. N.D. Ga. 1989) (“Under Georgia law, an alter ego claim is property of the estate under §541 and can be asserted by the Trustee.”).

One bankruptcy court has rejected an interpretation of Georgia law that would permit a corporation to pierce its own veil. Ellenberg v. Waliagha (In re Mattress N More, Inc.), 231 B.R. 104 (Bankr. N.D. Ga. 1998). While acknowledging that “it is difficult to predict what the state law is or would be when there is no state court case on point,” the court said it was “not

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See supra note 6 and accompanying text.
persuaded that a trustee can destroy the corporate fiction to make shareholders and related entities liable for all the debtor’s debts and the trustee’s administrative expenses.” *Id.* at 109, n.3. The court reached this decision after reviewing “principles of corporate jurisprudence and dozens of Georgia cases involving veil-piercing claims.” *Id.* at 109. It concluded that veil piercing is really a debt collection device for creditors, and stated that there “is something anomalous about a corporation, which is created to protect its shareholders from the liability of the enterprise, asserting a claim to destroy the very protection for which it was created.” *Id.* Thus, the court held that the alter ego claim was not property of the estate and could not be asserted by the trustee. *Id.* at 109-10.

The Georgia Court of Appeals has since decided a case that casts doubt on the rationale of *Mattress N More*. In *Paul v. Destito*, 250 Ga. App. 631, 550 S.E.2d 739 (2001), the defendants argued that “Georgia law does not allow a person who is a shareholder, director, and officer of a corporation to ‘pierce the veil’ of his own corporation.” *Id.* at 638, 550 S.E.2d at 747. The court disagreed, noting that it previously had allowed a 50 percent shareholder and director of a corporation to pursue a claim for piercing the corporate veil. *Id.* at 639, 550 S.E.2d at 747 (citing *Cheney v. Moore*, 193 Ga. App. 312, 312-13, 387 S.E.2d 575, 576 (1989)). Thus, the court rejected the “sweeping assertion that, in all cases, Georgia law prohibits a director, officer, or shareholder from piercing the corporate veil.” *Id.* The court, instead, focused on the standard in Georgia for piercing the veil, which it emphasized is rooted in equity concerns: “Georgia courts pierce the corporate veil ‘to remedy injustices which arise where a party has overextended his privilege in the use of a corporate entity in order to defeat justice, perpetrate fraud or evade contractual or tort responsibility.’” *Id.* (quoting *Cheney*, 193 Ga. App. at 312-13, 387 S.E.2d at 576). *Paul* indicates that the scope of potential plaintiffs in an alter ego action is not limited to creditors; rather it can include those who enjoy the protections of the corporate form. Thus, Georgia law does not require harm to a third party. Rather, it looks to whether there has been any abuse of the corporate form that has resulted in inequities. In light of the *Paul* case, the Court finds the reasoning in *Mattress N More* unpersuasive.

Some courts have made a distinction between general claims, belonging to all creditors, and personal claims, which are specific to one creditor. See, e.g., *St. Paul Fire & Marine Ins. Co. v. PepsiCo, Inc.*, 884 F.2d 688, 701 (2d Cir. 1989); *Koch Refining*, 831 F.2d at 1348-49; *City Communications*, 105 B.R. at 1022-23. Under this distinction, the trustee has standing to pursue general but not personal claims. The Court finds this distinction irrelevant to the inquiry at hand. See *Adam Furniture*, 191 B.R. at 257 n.6. The alter ego theory is one that could be used by any creditor seeking to recover money, and the path to the principal’s pockets must go through the debtor corporation. The Court is unable to hypothesize any set of circumstances in this case in which the principal’s disregard of the corporate form would create a particularized injury to one creditor. Furthermore, no such creditor-specific claim has been raised in this case. Once the corporate form has been disregarded, any unpaid creditor could argue for piercing the corporate veil. In bankruptcy, if the alter ego claim is property of the estate, all creditors are barred from
prosecuting such a claim by the automatic stay. “[A] section 362(a)(3) stay applies to a cause of action that under state (or federal) law belongs to the debtor[.]” *S.I. Acquisition*, 817 F.2d at 1150 (footnote added). As a result, a creditor cannot pursue the claim unless the trustee has abandoned it. *Steyr-Daimler-Puch*, 852 F.2d at 136.

Based on the foregoing the Court concludes as follows: A trustee has the exclusive right to bring an alter ego action if it is property of the bankruptcy estate. Any suits seeking an alter ego remedy filed by creditors are subject to the automatic stay unless the cause of action is abandoned by the trustee. Based on the *Paul* case, this Court predicts that under Georgia law, an alter ego claim may be asserted by the corporation and, thus, becomes property of the estate. Therefore, the alter ego claim against Thompson at issue here became property of the estate upon Debtor’s bankruptcy filing. As a result, Debtor in Possession has exclusive standing to pursue an alter ego claim against Thompson. Any suits initiated by the Creditors to recover unpaid debt on the theory that Thompson is the alter ego of Debtor violate the automatic stay.

Because the Court has held that the alter ego claim is property of the estate, it need not consider Thompson’s argument that DIP may enforce the Creditors’ alter ego claims pursuant to §544. Furthermore, because the Court has concluded that the automatic stay applies to the Edwards and Baillie cases, it need not consider whether to stay those cases pursuant to §105(a).

In light of the procedural posture of these cases, the Court will rule as follows: With respect to the Baillie case, Thompson and Debtor filed a complaint for injunctive relief to prevent Baillie from proceeding with an alter ego claim against Thompson. Because the Court has found that Baillie’s suit is subject to the automatic stay, a separate injunction is unnecessary. Therefore, the Court will grant Baillie’s motion for summary judgment and deny Thompson’s and Debtor’s motions for summary judgment. In the Edwards case, Edwards’ motion to remand remains outstanding. The Court will grant the motion for remand pursuant to 28 U.S.C. §1452(b), which allows remand on equitable grounds. The Court finds sufficient equitable grounds to remand the case. First, the Baillie case already is pending in state court with no chance of removal. Should the automatic stay be modified to allow the cases to proceed, it would

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7 “(a) [A] petition filed under section 301…of this title…operates as a stay, applicable to all entities, of…(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.” 11 U.S.C.A. §362(a)(3) (West 1993 & Supp. 2002).

8 §1452 reads, in relevant part, as follows:

(a) A party may remove any claim or cause of action in a civil action other than a proceeding before the United States Tax Court or a civil action by a governmental unit to enforce such governmental unit’s police or regulatory power, to the district court for the district where such civil action is pending, if such district court has jurisdiction of such claim or cause of action under section 1334 of this title.

(b) The court to which such claim or cause of action is removed may remand such claim or cause of action on any equitable ground.


An Order in accordance with this Opinion will be entered on this date
be more efficient and would lessen the possibility of inconsistent results to allow the same issue to be tried in a single forum. Second, as an issue of state law, the most appropriate forum for the case is the state court. See Wilson v. Alfa Cos. (In re Wilson), 207 B.R. 241, 249 (Bankr. N.D. Ala. 1996) (listing factors for consideration in a remand decision). However, like the Bailey case, the Edwards case is subject to the automatic stay.
We began to discuss preference avoidance in the last chapter’s overview of avoidance powers. In this chapter, we discuss preferences in a bit more detail. Recall that, generally speaking, Bankruptcy Code §547 allows the debtor to avoid a transfer to a creditor for an antecedent debt, made while the debtor was insolvent, if the transfer would allow the transferee to get more than he would get in a Chapter 7.

To understand preference law, turn to §547(b), which sets forth the *prima facie* case (subsection (a) includes a couple of definitions). If your case meets the affirmative elements of a preference under subsection (b), then you look at whether any of the exceptions, which are listed in §547(c), apply. Then you track through the rest of the statutes (and case law) for a bunch of nuances and qualifications.

Here is the *prima facie* case:

- a transfer made to or for the benefit of a creditor;
- made on account of an antecedent debt (that is, a debt that existed prior to the time of the transfer);
- made while debtor was insolvent (there is a rebuttable presumption of insolvency for the 90-day period prior to the bankruptcy filing);
- made within 90 days prior to the bankruptcy filing date, or one year if the transferee was an insider (“insider” is defined in §101(31) of the Bankruptcy Code); and
- the transfer enabled the recipient to receive more than he would have received if the transfer had not been made and the debtor were liquidated under chapter 7.

At the outset, notice the last requirement. It means, among other things, that transfers to fully secured or oversecured creditors are not avoidable preferences. We also think it means that a payment made for goods sold within 20 days before bankruptcy will often not be an avoidable preference, since such amounts would be paid in full (assuming administrative solvency) under §503(a)(9).

Some examples show how preference law work:

I. Vendor supplies widgets to Debtor. Prior to the petition date, Debtor has not been paying Vendor, but Vendor—hoping the situation is temporary—continues to ship widgets. Finally, Vendor gets fed up and tells Debtor it will stop shipping if the past-due balance isn’t paid immediately. Debtor pays the back due balance, and 30 days later it files bankruptcy petition. This is likely a preference.
II. Same situation as above, but the Debtor did not file bankruptcy until 91 days after the payment to Vendor. This would not be a preference, unless Vendor were an insider, since the preference look-back period is 90 days.

III. Debtor owes unsecured debt to Lender. Lender is nervous that Debtor is insolvent and Lender fears Debtor may default on the loan. To appease Lender, Debtor grants Lender a mortgage on Debtor’s headquarters building. Three weeks later, Debtor files bankruptcy. No payments involved here, but the granting of the mortgage lien is a “transfer” on account of an “antecedent debt” and therefore likely avoidable as a preference.

IV. Debtor owes Secured Lender $7 million, secured by all Debtor’s real estate and accounts receivable. These security interests are properly perfected and the collateral is worth $12 million. The loan is in default and Secured Lender is threatening to foreclose, which would put Debtor out of business. So Debtor pays the $7 million and then, two days later, files bankruptcy. Sounds like it might be a preference—but probably not. Because Secured Lender is oversecured, it would be paid in full in a Chapter 7 liquidation, and so the payment it received from Debtor did not enable it to receive more than it would have received in a Chapter 7. So, no preference. The lesson: prepetition payments to fully secured and oversecured creditors are not preferential.

These are relatively simple examples. Here are two that are a bit more complicated—but more common than you might imagine:

V. Debtor borrows $100 from Charlie and gives Charlie a security interest in Debtor’s defenestrator. Debtor signs a UCC-1 financing statement, but Charlie forgets to file it in the public records. Debtor files for bankruptcy. The debtor (even though we use “debtor” throughout, this is technically wrong—it is the trustee or DIP) gets to avoid Charlie’s security interest—but not as a preference. Rather, the DIP debtor avoids it using his “hypothetical lien creditor” power under §544(a)(1). A lien creditor could have avoided this unperfected security interest at state law absent bankruptcy; the debtor steps into the shoes of the lien creditor and avoids the transfer.

VI. Debtor borrows $100 from Charlie and gives Charlie a security interest in Debtor’s defenestrator. Debtor signs a UCC-1 financing statement. Charlie forgets to file it. Months pass. Charlie discovers his error and then files the financing statement. Next day, Debtor, hopelessly insolvent, files for bankruptcy. Note that the DIP cannot avoid this transfer using his lien creditor power, because he gets the rights of a lien creditor only as of the day of bankruptcy, and as of the day of bankruptcy, a lien creditor could not have avoided this (late-filed) transfer. But wait. On these facts, the Bankruptcy Code (§547(e)(2)) provides that the giving of security is a transfer “made” only when “perfected,” i.e., when it was filed. And when it was made/perfected/filed, it was a transfer for an antecedent debt. So, it is avoidable as a preference. The lesson: a late-filed security interest may be avoidable as a preference.

But that is not quite the end of it. Bankruptcy Code §547(e) provides that a security interest is “made” when it is “perfected.” But it also adds an extra fillip: a grace period for late
filing. It provides that a security interest is made when it is effective between the parties if it is perfected within 30 days thereafter. So:

VII. On Day 1, Debtor borrows $100 from Creditor, giving Creditor a security interest in his defenestrator. Debtor signs a financing statement, but Creditor forgets to file it until Day 60. No grace period: the transaction is “made” at Day 60.

VIII. Same as #1, except that Creditor files on Day 29. The grace period kicks in: the transaction is “made” at Day 1.

IX. Contrast: On Day 1, Debtor signs and Creditor files a UCC-1 financing statement. On Day 9, Debtor borrows $100 from Creditor, giving Creditor a security interest in his defenestrator. The transaction is “made” at Day 9. There is a grace period for late filing, but not for a late agreement.

There is actually a second “grace period” rule: this one is in §547(c), the “exceptions” section. Recall: §547(c) identifies several transactions that will not be avoidable—exceptions to the preference rules of §547(b). It applies to the “purchase money” transactions—the case of a seller who sells goods on credit, or the lender who banks the sale. The purchase-money creditor gets 30 days to complete the perfection of his security interest. If the holder of a purchase money security interest perfects within 30 days after the debtor receives possession of the property, it will not be a preference. This section no longer dovetails with the 20-day grace period in U.C.C. §9-317(e) as a result of its 2005 amendment.

Note that this purchase-money rule protects a seller or a lender only if there is a security interest. Without a security interest, we would expect the seller to find himself restricted to sharing with the other unsecured creditors. There is, as it happens, one thread of hope for the unsecured seller, although it is pretty thin. Bankruptcy Code §546(c) provides a limited right for a seller of goods to reclaim his goods from the bankruptcy estate. To do so, the seller must make a demand in writing within 45 days of the petition date. It appears that this is a federal right of reclamation that is independent of any state law right like that of U.C.C. §2-702. However, the right is subject to senior liens on inventory, so in many cases it is likely to be ineffective. Another hope for the seller may be §503(b)(9), new as of 2005, which provides administrative priority for goods sold to the debtor in the ordinary course of business within 20 days before the bankruptcy filing.

There are a number of other “defenses” or “exceptions” to the preference laws, in §547(c). Any time you have a preference case, it’s a good idea to go through all the §547(c) provisions to see whether any of them might apply. We discuss a few of the more common ones below.

Section 547(c)(1) provides an exception for a “substantially contemporaneous exchange.” This is easy enough to follow: the debtor takes delivery of a five-pound sack of birdseed; he passes to the seller a $5 bill. We can see why you don’t want to treat this as a preferential transfer; the debtor gave as good as he got, and the estate is no worse off. Our example probably is not a preferential transfer at all (where’s the “antecedent debt”?) and so not in need of an exception. But if the debt were created on day one and repaid two days later, and the parties
intended the transaction to be a contemporaneous exchange, it should still qualify for the defense—even though technically the payment was for an “antecedent debt.”

Another important defense is referred to as “subsequent new value.” Consider this case: Debtor owes $100 to creditor, unsecured. Eighty-nine days before bankruptcy, the insolvent Debtor pays Creditor in full. This looks like a preferential transfer. But now, suppose that 88 days before bankruptcy, Creditor lends Debtor another $100. Can the Debtor avoid the payback that was made on Day PD-89 (89 days before the Petition Date) as a preferential transfer?

Bankruptcy Code §547(c)(4) says no. It provides that we won’t avoid the first transfer where the Creditor extends “new value” after it received a preferential repayment. If the new value is less than the amount of a preference payment, it does not eliminate the recipient’s preference liability, but serves as an offset to the extent of the new value. There is some dispute among courts as to how subsequent new value credit should be calculated; that is beyond the scope of this general discussion, but you should review the different approaches if you have a case where this is an issue.

Another subsection of §547(c) provide more general limitations on the power of the trustee to avoid preferential transfers. One is §547(c)(2). It provides an exception for transfers “in the ordinary course.” Consider this case: DebtorCo is deeply insolvent, just days away from bankruptcy. But, it pays all its utility bills for utility service provided the prior month when the bills for those services arrive that day—just as it always does. If DebtorCo pays—even if he pays on schedule—it looks like a payment on an antecedent debt. But if it passes the “ordinary course” test, it is not avoidable. There are slight differences in the way courts articulate the “ordinary course” test, but as a general matter if a payment is made on terms that are (1) consistent with the historical course of dealings between the debtor and creditor, or (2) on terms that are customary in the industry, they are likely to be protected by the ordinary course defense.

To explore the implications of this “ordinary course” defense, take a second look at the prima facie case in §547(b), particularly §547(b)(4) which concerns itself with the matter of timing. Bankruptcy Code §547(b)(4)(A) provides that the DIP may avoid a preferential transfer if the transfer was made “on or within 90 days before the date of the filing of the petition.” This is straightforward enough: if the debtor made the preferential transfer 91 days before bankruptcy it is unavoidable; if 89 days, then the DIP may avoid it.

Next, look at §547(b)(4)(B). It provides a special reach-back rule if the transferee is an “insider.” In the “insider” case, the trustee is not bound by the 90-day limit. To undo an otherwise preferential transfer, he can reach back as far as a year.

What is the point of this? The rule is easy enough to understand if you think of the ordinary family business, where the company president may be a shareholder, and also a creditor. As an “insider” (see the definition in §101(31)), the president is in a position to know how bad off the debtor is. He is also in a position to decide who gets paid, and who does not. So it is not surprising that we put him on a tighter leash. But keep in mind that even in the case of an insider preference, the Bankruptcy Code still requires that the debtor have been insolvent at the time of the transfer, and the trustee only has the benefit of the presumption of insolvency during
the 90 days immediately preceding the bankruptcy filing—so the cases between 90 days and one year can sometimes be harder for the trustee to prove.

Bankruptcy Code §547(c)(9) additionally provides a safe harbor for payees that received an aggregate of less than $5,000 in the 90-day period.

Finally, we need to consider the issue of “transferee knowledge” in preference cases. Consider this example: Debtor-Supermarket owes $100 to Butcher on a demand note. Unknown to Butcher, Debtor-Supermarket also owes $100 to Baker and $100 to Candlestick Maker. Debtor-Supermarket has only $100, with no prospect of getting more. Butcher needs some ready cash; he calls the note and demands payment. Debtor-Supermarket pays Butcher and then, 89 days later, files for bankruptcy. This sounds like an avoidable preference, and the curiosity is this: nowhere in this sketch do we suggest that the Butcher knew anything about Debtor’s financial situation, or that he was trying to nose out other creditors. The point is that the DIP doesn’t have to prove such transferee knowledge. It simply is not part of the prima facie case. This rule has always been somewhat contentious among bankruptcy professionals—and certainly among trade creditors who get sued simply because the debtor paid a legitimate debt owed to them. Indeed, it was not always thus: under pre-1978 law, the trustee had to show that the transferee knew that the debtor was insolvent at the time of the transfer.

A final note: The overwhelming majority of preference cases are brought under federal law—Bankruptcy Code §547. But some states also have preference laws, and the debtor can use those laws too. See §544. As a debtor (and, again, when we talk about a “debtor’s” avoidance powers throughout, we are using it as shorthand to mean the trustee or debtor-in-possession) considering a preference action, it is worthwhile having a look at state law; you might find something of use.
APPENDIX 7(a)
IN RE KMArt CORP.

This following edited order illustrates, among other things, the operation of the preference statute and its “strict liability” standard if one cannot meet any of the enumerated defenses of §547(c).

318 B.R. 409 (Bankruptcy Court N.D. Ill. 2004)

This matter comes before the court on the motion of the plaintiff Kmart Corporation to Strike and/or for Judgment on the Pleadings with Respect to Certain Affirmative Defenses. For the reasons stated herein, the motion is granted in part and denied in part.

I. Background


On Jan. 22, 2002 (the “Petition Date”), Kmart Corporation and 37 affiliates filed voluntary petitions for reorganization under chapter 11 of title 11 of the United States Code (the “Code”). On May 2, 2003, Kmart Corporation (“Kmart”) filed an adversary complaint against Uniden America Corporation (“Uniden”) seeking to recover $5,666,485 in transfers made to Uniden within the 90 days preceding the Petition Date pursuant to sections 547 and 550 of the Code. Uniden filed an answer and eleven affirmative defenses on July 1, 2003. On Jan. 8, 2004, Kmart filed a Motion to Strike and/or for Judgment on the Pleadings With Respect to Certain Affirmative Defenses.

II. Discussion

A. Standards on a Motion to Strike Affirmative Defenses

Rule 8(c) of the Federal Rules of Civil Procedure, which is made applicable herein by Federal Bankruptcy Rule 7008(a), requires a party to set forth affirmative defenses in a responsive pleading. An affirmative defense is not a simple denial of the allegations of the complaint. Rather, when asserting an affirmative defense, the defendant is essentially admitting the allegations of the complaint, but pleading some reason extraneous to the plaintiff’s prima facie case that would excuse or exculpate the defendant from liability. Because they are pleadings, affirmative defenses are subject to being stricken. Motions to strike affirmative defenses are governed by Rule 12(f) of the Federal Rules of Civil Procedure, which is made applicable herein by Federal Bankruptcy Rule 7012(b). That rule provides:

Upon motion made by a party before responding to a pleading or, if no responsive pleading is permitted by these rules, upon motion made by a party within 20 days after the service of the pleading upon the party or
upon the court’s own initiative at any time, the court may order stricken
from any pleading any insufficient defense or any redundant, immaterial,
impertinent, or scandalous matter.

Kmart’s motion to strike is untimely, as it was filed beyond the deadline. Rule 12(f),
however, permits a court, in its discretion and on its own initiative, to strike defenses at any time.
Accordingly, although the motion is untimely, the court has authority to and will consider
striking the questioned defenses.

Motions to strike are disfavored, sparingly used, and should not be granted unless it
appears to a certainty that plaintiffs would succeed despite any state of the facts which could be
proved in support of the defense…and are inferable from the pleadings. In other words, before
granting a motion to strike an affirmative defense, the court must be convinced that there are no
questions of fact, that any questions of law are clear and not in dispute, and that under no set of
circumstances could the defense succeed.

The examination of affirmative defenses on a motion to strike, essentially involves three
considerations, i.e., whether the matter is appropriately plead as an affirmative defense, whether
the defense is adequately plead under the requirements of Rules 8 and 9, and the legal
sufficiency of the defense.

A matter is not appropriately plead as an affirmative defense if it is a denial of an element
of the prima facie case. An affirmative defense that is really a denial of an element of the
plaintiff’s case is said to be mislabeled or mistakenly titled. It is understandable that cautious
pleaders sometimes mislabel defenses, given the potential for waiver of a defense that is not
asserted in a responsive pleading. Under these circumstances, the benefit should be given to the
cautious pleader and the mistaken labeling will usually be excused.

An affirmative defense is inadequately plead if it fails to satisfy the federal notice
pleading requirements. Under Rules 8 and 9, a pleader must state his defense in short and plain
terms, and if the defense is grounded in fraud or mistake, the circumstances constituting the
fraud or mistake must be stated with particularity.

In this circuit, “bare-bones,” conclusory allegations do not meet the pleading
requirements. It is unacceptable for a party’s attorney simply to mouth [affirmative defenses] in
formula-like fashion (‘laches,’ ‘estoppel,’ ‘statute of limitations,’ or what have you), for that
does not do the job of apprising opposing counsel and this court of the predicate for the claimed
defense—which after all is the goal of notice pleading

Even if an affirmative defense is appropriately and adequately plead, it may still be
stricken for lack of legal sufficiency. The legal sufficiency of an affirmative defense is gauged
under the same standards as a motion to dismiss a complaint pursuant to Rule 12(b)(6). That is,
the defense will be stricken as legally insufficient, if it is impossible for defendants to prove a set
of facts in support of the affirmative defense that would defeat the complaint.

The sufficiency of the defense turns, at least in part, on the substance of the cause of
action it seeks to defeat. The complaint here seeks the recovery of transfers from Uniden that
Kmart asserts are preferential under §547 of the Code. Section 547(b) of the Code empowers the trustee to:

- avoid any transfer of an interest of the debtor in property:
  1. to or for the benefit of a creditor;
  2. for or on account of an antecedent debt owed by the debtor before such transfer was made;
  3. made while the debtor was insolvent;
  4. made:
     A. on or within 90 days before the date of the filing of the petition; or
     B. between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
  5. that enables such creditor to receive more than such creditor would receive if:
     A. the case were a case under chapter 7 of this title;
     B. the transfer had not been made; and
     C. such creditor received payment of such debt to the extent provided by the provisions of this title.


The trustee’s power to avoid any transfer that meets the stated requirements is limited by §547(c) of the Code, which sets forth a number of exceptions to that avoidance power. For example, the trustee may not avoid a transfer to the extent that the transfer was intended by the debtor and the creditor to be a contemporaneous exchange for new value given to the debtor and in fact was a substantially contemporaneous exchange. 11 U.S.C. §547(c)(1). Section 547(b) thus establishes the scope of the trustee’s avoidance powers relating to preferences and §547(c) limits that power by enumerating specific exceptions to it.

Another limitation on the avoidance power can be found in §550(a) of the Code, which has been construed to prohibit the trustee from bringing avoidance actions, including preference avoidance actions, that do not benefit the estate.

Those enumerated exceptions are typically brought as and considered affirmative defenses to the preference complaint. Many courts, including this one, have held that the enumerated 547(c) preference exceptions are the exclusive defenses to liability for an otherwise avoidable preferential transfer. The rationale is that under rules of statutory construction, where
Congress enumerates exceptions to a general prohibition, additional exceptions are not to be implied, absent a contrary legislative intent.

Such a holding, however, should not be construed to preclude the assertion of those types of affirmative defenses that are referred to by Judge Squires in \textit{Stoecker} as “threshold challenges.” Threshold defenses are those defenses that would bar recovery, before even opening the door to consider the substantive nature of the claim. Examples of threshold defenses include, “lack of in personam jurisdiction, service of process, standing, and the like.” \textit{Stoecker}, 131 B.R. 979, 983 (Bankr. N.D. Ill. 1991). This court adopts the reasoning of \textit{Stoecker} and concludes that the only defenses to the substance and merits of a preference action available to a defendant are those enumerated in the Code.

\textbf{B. Uniden’s Affirmative Defenses}

The defenses subject to this motion were plead by Uniden as follows:

\textit{Third Affirmative Defense.} The Debtors’ claims against Uniden are barred under the doctrine of unclean hands.

\textit{Fourth Affirmative Defense.} The Debtors’ claims against Uniden are barred under the doctrine of waiver.

\textit{Sixth Affirmative Defense.} The Debtors’ claims against Uniden are barred by the Debtors’ fraud upon its trade creditors, including, without limitation, the Debtors’ intentional and willful attempts to withhold and delay payments and to otherwise engage in deceptive acts and misrepresentations to forestall payments to trade creditors through an undisclosed program known as “Project Slow it Down” or “Project SID.”

\textit{Seventh Affirmative Defense.} The Debtors’ claims against Uniden are barred under the doctrine of equitable estoppel.

\textit{Eight Affirmative Defense.} The Debtors’ claims against Uniden are barred for improper venue.

\textit{Eleventh Affirmative Defense.} To the extent that any transfers to Uniden are deemed to be preferential, such transfers are subject to, and Uniden hereby asserts, its rights of setoff and/or recoupment.

The eighth defense of improper venue is a threshold defense. If venue is indeed improper, the ability of Kmart to recover the alleged preferential transfers would be barred, at least in this court. Venue of this adversary proceeding, however, is properly in this court where the underlying bankruptcy cases are pending. 28 U.S.C. §1409(a). Accordingly, Uniden’s eighth affirmative defense of improper venue is stricken as being patently defective and incapable of succeeding under any circumstances…
The court concludes that Uniden’s waiver and equitable estoppel defenses should be counted among those considered as threshold defenses. In addressing the similarities between waiver and equitable estoppel, the Seventh Circuit stated,

Recently…we had occasion to discuss the principles of waiver and estoppel. Waiver, we pointed out, focuses on intent. If an individual intentionally relinquishes a known right, either expressly or by conduct inconsistent with an intent to enforce that right, he has waived it. Estoppel, on the other hand, focuses on the effects of the conduct of the obligee. It arises when a party’s conduct misleads another into believing that a right will not be enforced and causes the other party to act to his detriment in reliance upon this belief.

J. H. Cohn & Co. v. American Appraisal Associates, Inc., 628 F.2d 994, 1000 (7th Cir. 1980) (citations omitted). It is conceivable that the right to bring the preference complaint may have been waived. Likewise, it is possible that misleading conduct on the part of the holder of the right to bring a preference action, which was detrimentally relied upon by the potential preference defendant, may work to estop enforcement of the preference recovery right. Under both scenarios, the right of recovery would be barred before even getting to the substance of the preference claim.

Thus, the waiver and equitable defenses are threshold challenges available to Uniden. Accordingly, the court will not strike Uniden’s fourth and seventh defenses on the grounds of legal insufficiency. Those defenses will be stricken, however, because as presently stated in the pleading, they are conclusory, bare-bones allegations and thus fail even under the liberal pleading requirements of Rule 8. Because the deficiency is a technical one and there is no asserted prejudice to Kmart, Uniden is given leave to amend those defenses.

Numerous courts have held that the defenses of setoff and/or recoupment are not legally sufficient defenses to a preference complaint. See Stoecker, 131 B.R. at 983 and cases cited therein. Prior to the petition date in Stoecker, a bank’s loan to the debtor was fully secured by certificates of deposit. The bank argued that the debtor fraudulently, through the use of materially false and misleading financial statements, convinced the bank to release a large sum of money from the CDs to the debtor, thus causing the bank to become partially unsecured. The debtor subsequently paid down a portion of the loan with two payments made to the bank within 90 days of the bankruptcy filing. After the bankruptcy case was filed, the trustee sought to recover those payments as preferential transfers. In response to the preference complaint, the bank asserted that the preferential transfers arose out of the same transaction in which the bank was defrauded by the debtor. In other words, “but for [the debtor’s] alleged fraud, [the bank] would not have released some its collateral to [the debtor] and [the debtor] thereafter would not have made the transfers back to the bank.”

The court rejected that recoupment defense (and the related set-off defense) on two grounds. First, as a substantive matter, there was no way for the defense to succeed given that the trustee’s statutory claim against the bank and the bank’s claim against the debtor did not arise from the same transaction. Second, the court held that the recoupment and setoff defenses were not among the enumerated substantive 547(c) defenses exclusively available to preference
defendants. The court refused to “broaden the exceptions under §547(c) on the merits and substance of an otherwise avoidable preference to include the defense of recoupment.” Id. at 983-84. By striking the defense, the court implicitly held that the setoff/recoupment defense did not qualify as a threshold defense.

In reaching its decision, the court noted another “critical flaw” in the bank’s argument. The bank incorrectly relied on the debtor’s alleged fraud absent which the bank would not have released the funds, and thus become unsecured and vulnerable to a preference complaint. To the court, “fraud is neither an element of proof on a prima facie preference avoidance action under §547(b),” nor one of the enumerated defenses to the merits of such an action. Id. at 984. Further, “proof of [the debtor’s] actual or constructive fraud or the Bank’s good faith in accepting the payments after releasing some of the collateral is simply irrelevant and immaterial in preference actions, unlike the law on fraudulent transfer actions brought under sections 548 and 544(b).” Id.

Unlike a fraudulent transfer avoidance action, the express congressional policy of preference actions is to achieve equal treatment of all creditors of the same priority, and thus undo the effects of asset grabs on the eve of bankruptcy. “Thus, the Bank’s arguments that it would not have received the alleged preferential transfers but for [the debtor’s] claimed fraud, are both insufficient and irrelevant as a matter of law. That the Bank, acting in good faith, may have been a victim of fraud is no defense to the fact that it received the subject payments to the exclusion of [the debtor’s] other unsecured creditors.” Id.

The reasoning in Stoecker is persuasive. Setoff or recoupment is not a legally sufficient defense to a preference action that would bar recovery of a preference claim. They are not among the enumerated exceptions and are contrary to the purpose of empowering the trustee to recover preferences. Moreover, they are not threshold defenses because they would necessarily require an analysis of whether the preference claim and the claim the defendant seeks to setoff or recoup against it arose from the same transaction. Accordingly, Uniden’s eleventh affirmative defense of setoff and/or recoupment is stricken without leave to replead.

Uniden, in supporting its fraud and unclean hands defenses, is essentially arguing the same thing as the bank did in Stoecker. To Uniden, but for the fraud allegedly perpetrated by Kmart in the months just preceding the bankruptcy filing in connection with a deliberate corporate policy fittingly named “Project Slow it Down,” Uniden would not have been in the position of defending a preference complaint. Because of that purported fraud, which effectively soiled Kmart’s hands, the recovery of the preferential transfers should be barred. Even assuming Uniden was a victim of fraud and/or bad faith on the part of Kmart, the purportedly malicious intent of Kmart in making the alleged preferential transfers, which may somehow be related to Project Slow it Down, is immaterial to whether those transfers are recoverable. The quality of the preference transferor or recipient’s faith is also immaterial. Accordingly, Uniden’s third and sixth affirmative defenses are legally insufficient and are therefore stricken without leave to replead.

C. Judgment on the Pleadings

Fearing that its untimely motion to strike would not be considered, Kmart alternatively requested the entry of judgment on the pleadings pursuant to Rule 12(c). Rule 12(c) allows for the entry of a judgment at the close of pleadings. Although it is recognized that Rule 12(c) can
serve as an “auxiliary device” to raise procedural pleading defects, the rule is customarily invoked when there are no issues of disputed fact and movant is entitled to judgment on its *prima facie* case at the close of pleadings. *Alexander v. City of Chicago*, 994 F.2d 333, 336 (7th Cir. 1993). Under its customary application, a Rule 12(c) motion is treated like a summary judgment motion and should be granted “only if on the admitted facts the moving party is clearly entitled to judgment.” 10 *COLLIER ON BANKRUPTCY* P7012.5 (Alan H. Resnick & Henry J. Sommer eds., 15th ed. rev.). Here, the pleading deficiencies have been addressed in the context of the motion to strike. In addition, Uniden expressly denied the allegations essential to Kmart’s *prima facie* case and has raised a number of the preference exceptions as affirmative defenses. As such, there are issues of fact and Kmart is not entitled to judgment on the pleadings.

III. Conclusion

For the reasons stated, the motion to strike the Uniden defenses is granted. The third, fourth, sixth, seventh, eighth and eleventh defenses are stricken. Uniden is given leave to amend its fourth and seventh defenses. Kmart’s alternative request for judgment on the pleadings pursuant to Rule 12(c) is denied.
APPENDIX 7(b)
IN THE MATTER OF: RAMBA INC.
Appendix 7(b) - In The Matter of
Ramba Inc.

Chapter 11-101

United States Court of Appeals
Fifth Circuit

REVISED FEBRUARY 16, 2006
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 04-20752

In The Matter Of: Ramba Inc.
Debtor

LOWELL T. CAGE,

Appellant,

v.

WYO-BEN, INC.; GEORESOURCES, INC.; TRANS-CAPITAL, INC.;
M-I, LLC, doing business as Federal Wholesale Drilling
Mud; SCHLUMBERGER TECHNOLOGY CORP., doing business as
Dowell Schlumberger; AMCHEM, INC.; ENTERPRISE FLEET
SERVICES; DANOS & CUROLE Marine Contractors, INC.;
MILWHITE, INC.; EXCALIBAR MINERALS, INC.

Appellees.

Appeal from the United States District Court
for the Southern District of Texas

Before REAVLEY, GARZA, and BENAVIDES, Circuit Judges.

BENAVIDES, Circuit Judge:

This case involves a trustee's attempt to avoid transfers to
creditors in a Chapter 7 bankruptcy. The district court granted
summary judgment to the Appellees, holding that indirect transfers
to ten creditors did not constitute voidable preferences. It
reached this conclusion after holding that the transfers were in the
ordinary course of business and that the transfers were made from property in which the debtor had no interest. We AFFIRM on the grounds of the second holding and therefore do not reach the first. The district court also considered one direct transfer. It erred when it found that the transfer was in the ordinary course of business. Therefore, we AFFIRM in part and VACATE and REMAND in part.

I. FACTUAL AND PROCEDURAL BACKGROUND

On November 21, 2000, Ramba, Inc. filed for Chapter 7 bankruptcy. The Trustee, Lowell Cage, filed numerous proceedings against entities who received transfers from Ramba, including actions against the Appellees. The Appellees are ten vendors who provided materials, equipment, and services to Ramba’s drilling division.¹ After a request for a jury trial, the proceedings were removed to the district court and consolidated into one case.

All but one of the transfers at issue resulted from the sale of Ramba’s drilling division to a subsidiary of Patterson Energy, Inc. Ramba and Patterson entered an “Asset Purchase Agreement” on September 30, 2000, two months prior to the bankruptcy filing, while Ramba was doing business as Ambar, Inc. The transaction required Ramba to sell all the assets of its drilling division, and, as part

of the consideration, Patterson assumed some of Ramba’s liabilities. Those liabilities included debts owed to the Appellees. Ramba also sold Patterson the rights to the name “Ambar.” A Patterson subsidiary later began doing business as “Ambar Drilling.”

Prior to the selling of the division, Ramba owed Citibank more than $25 million under a credit agreement dated August 14, 1997. Pursuant to that agreement, Ramba granted Citibank liens on all its assets, including the assets ultimately sold to Patterson. The result was that Citibank’s security interests wholly encumbered Ramba’s assets, exceeding their fair market value. As part of and essential to the sale to Patterson, Citibank agreed to release its security interests in the assets of the drilling division and to allow some of the purchase price to go toward paying Ramba’s debts. The result of the deal was that Patterson received the assets “free and clear” of all liens and paid Citibank $15.6 million in full and final satisfaction of its liens. Patterson then paid the remainder of the consideration, approximately $10 million, to Ramba’s creditors, the Appellees.

The Trustee attempts to set aside as preferential the transfers to the Appellees that resulted from the sale to Patterson and one “direct” transfer made by Ramba to Appellee GeoResources. The district court held that these transfers did not constitute voidable preferences. The decision constituted an appealable final judgment.

See Sink v. United States, 929 F.2d 1015, 1020 (5th Cir. 1991) ("A
judgment is final when it terminates litigation on the merits and leaves the court with nothing to do except execute the judgment.”

II. STANDARD OF REVIEW

This Court reviews a district court’s grant of a summary judgment de novo, applying the same standards as the district court. Hirnas v. Nat’l R.R. Passenger Corp., 95 F.3d 396, 399 (5th Cir. 1996). The evidence should be viewed in the light most favorable to the nonmoving party, and the record should not indicate a genuine issue as to any material fact. Am. Home Assurance Co. v. United Space Alliance, 378 F.3d 482, 486 (5th Cir. 2004). This Court reviews factual findings for clear error. In re Mercer, 246 F.3d 391, 402 (5th Cir. 2001).

III. DISCUSSION

A. Indirect Transfers to Appellees

Section 547(b) of the Bankruptcy Code establishes the six elements of any preference action. To be a preference there must be:

1. “a transfer of an interest of the debtor in property;”
2. “to or for the benefit of a creditor;”
3. “for or on account of an antecedent debt owed by the debtor before such a transfer was made;”
4. “made while the debtor was insolvent;”
5. “made on or within 90 days before the date of the filing of the petition” (or one year if an insider);
and
(6) one "that enables such creditor to receive more
than such creditor would receive" if (A) the debtor
filed under Chapter 7, and (B) the transfer had not
been made.

11 U.S.C. § 547(b) (2000). The transfers at issue fail to meet the
first element.

A debtor has an interest in property if that property would
have been part of the debtor’s bankruptcy estate had the transfer
not occurred. See In re Criswell, 102 F.3d 1411, 1416 (5th Cir.
1997). A trustee cannot avoid transfers of property unless the
property would have been in the estate and therefore available to
the debtor’s general creditors. Warsco v. Preferred Technical
Group, 258 F.3d 557, 564 (7th Cir. 2001). Essentially, a voidable
preference must have depleted the estate. Gulf Oil Corp. v. Fuel
Oil Supply & Terminaling, Inc., 837 F.2d 224, 230-31 (5th Cir.
1988). A trustee bears the burden of proving that the debtor had
an interest in the transferred property. Warsco, 258 F.3d at 564.

The Bankruptcy Code offers further explanation of what assets
fall within a bankruptcy estate. Section 541 of the Code states:

Property in which the debtor holds, as of the
commencement of the case, only legal title and not an
equitable interest . . . becomes property of the estate
. . . only to the extent of the debtor’s legal title to
such property, but not to the extent of any equitable
interest in such property that the debtor does not hold.

11 U.S.C. § 541(d). There can be no preference when a debtor
transfers property in which the debtor has no equitable interest.

See In re Bean, 252 F.3d 113, 117 (2d Cir. 2001); In re Parham, 72
B.R. 604, 605 [Bankr. M.D. Fla. 1987]; In re Central States Press, 57 B.R. 418, 422 (Bankr. W.D. Mo. 1985) ("Even the most liberal rules permitting recovery under § 547 . . . apply only to the extent that the value of the collateral transferred exceeds the indebtedness of the debtor on the security interest.").

In In re Maple Mortgage, Inc., 81 F.3d 592, 595 (5th Cir. 1996), we held that funds at issue in a preference dispute must have been available for distribution to general creditors. "[I]f funds cannot be used to pay the debtor's creditors, then they generally are not deemed an asset of the debtor's estate for preference purposes." Id. While Maple Mortgage did not specifically address whether a debtor's bankruptcy estate includes fully encumbered property, it recognized the common sense reasoning that funds must be available to pay creditors. Other courts have reached similar results, holding that a bankruptcy estate is made up of equity, as opposed to legal title alone. See, e.g., In re Mahendra, 131 F.3d 750, 755 (8th Cir. 1997) (holding that "[a]ny portion of a debtor's property that is unencumbered by mortgage—the equity—is part of the bankrupt's estate."); U.S. v. Rauer, 963 F.2d 1332 (10th Cir. 1992) (same).²

²When a debtor holds only legal title to fully encumbered property during a Chapter 7 bankruptcy, the trustee typically abandons the property because the estate cannot benefit from its sale. For that reason, few cases exist that involve a dispute as to whether fully encumbered property can be property of an estate.
At the time of the drilling division sale, it is undisputed that Ramba’s assets were fully encumbered by Citibank’s liens.\(^3\) Ramba had no equity in the proceeds of the sale, and, therefore, the funds never would have been available to general creditors in the bankruptcy. The Trustee argues that upon Citibank’s acceptance of $15.6 million from Patterson, the “assumed liability” portion of the purchase price was converted into unencumbered funds, which presumably Ramba could then distribute to creditors as it wished in the resulting bankruptcy. This theory fails because there is no evidence that Citibank agreed to create equity for the benefit of Ramba. The consideration from the sale of Citibank’s collateral belonged to Citibank, the secured lender.

The problem with Ramba’s lack of equity is illustrated by the remedy the Trustee is requesting. The Trustee wants a refund of the $10 million paid to the Appellees by Patterson. By doing so, he essentially is asking for the benefit of the deal with Patterson while cancelling one of the underlying terms of the bargain. The district court points out that without the debt assumption provision, it is likely that there would never have been a deal with Patterson. The court opined, “A drilling outfit that has difficulty getting basic materials like mud and care is not an attractive

\(^3\)During oral argument, the attorney for the Trustee admitted that “the debt and the assets are roughly equivalent,” describing the assets as “fully encumbered.” Indeed, the record shows that the Trustee stipulated to the fact that “Citibank was owed in excess of the fair market value of the Debtor’s total assets.”
asset." The Patterson transaction was structured so that the drilling division would operate without interruption, as seen by Patterson’s choice in adopting the "Ambar" name. The district court found that only one of the Appellees even knew the division had a new owner. The Trustee’s request threatens to undo the entire Patterson transaction. Such an undoing would leave Citibank holding liens on the drilling division and the Trustee having an asset that would not benefit general creditors.

The Trustee’s reliance on In re Conard Corporation, 806 F.2d 610 (5th Cir. 1986), is misplaced. In Conard, the debtor sold pizza restaurants to a third party. As part of the transaction, the buyer agreed to assume and be bound by eighty-four installments on an unpaid promissory note. Id. at 611. This Court held that those payments were voidable preferences because the assumption of debt provision prevented the debtor’s estate from benefitting from a higher selling price. Id. Conard, however, is easily distinguished. The restaurants were unencumbered at the time of the sale, giving the debtor an equitable interest in the asset. Here, Ramba only held legal title at the time of the Patterson transaction. Had Patterson been willing to pay a higher price for the assets rather than assuming the debt, the increase in funds would have gone to Citibank, not the estate.4

4The Trustee also fails in his argument that the district court and the Appellees misinterpret section 541(d). He says "equitable" as used in section 541(d) only applies to secondary
Ramba had no interest in the transferred property other than bare legal title. This is insufficient for avoiding the transfers to the Appellees. Because we affirm on this ground, we need not address the district court's holding that the transfers occurred in the ordinary course of business. Similarly, we need not address alternative arguments presented by the Appellees.  

B. Direct Transfer to Appellee GeoResources  

The Trustee attempts to recover one "direct" payment to GeoResources in the amount of $28,396.83 paid on September 8, 2000. The September payment totaled $31,899.03, but only $28,396.83 is at mortgage situations where a real estate purchaser has paid the full amount due but has not yet received a deed. Id. He concludes that section 541(d) does not apply to Ramba and relies on section 541(a)(1), which provides that the bankruptcy estate is comprised of "all legal and equitable interests." 11 U.S.C. § 541(a)(1) (emphasis added). The United States Supreme Court and this Court, however, have applied section 541(d) outside the equitable mortgage context. See, e.g., Bagier v. IRS, 496 U.S. 53, 59 (1990) (examining trust funds paid to the IRS under section 541(d)); In re Haber Oil Co., Inc., 12 F.3d 425 (5th Cir. 1994) (examining constructive trusts under section 541(d)). In addition, this Court reads section 541(d) in conjunction with section 541(a)(1) rather than as two distinct, inconsistent provisions. In re Maple Mortgage, 81 F.3d at 595 (explaining that section 541(d) "further explains" section 541(a)(1)).

Appellees argue that the payments are not voidable preferences because Ramba contemporaneously received new value in exchange for the transfers. Appellees also argue that they did not receive more than they would have under a liquidation, a requirement under section 547(b).

The briefs varied in their descriptions of the direct transfer payments at issue. At oral argument, the attorney for the Trustee clarified the discrepancies, stating that the Trustee only sought to avoid $28,396.83 of the September payment.
issue. This payment came directly from Ramba as opposed to being paid by Patterson.

The parties disagree as to whether the GeoResources payment satisfies the Bankruptcy Code's exception for payments made in the ordinary course of business. The disagreement centers on the timing of the payments and whether the timing met the requirement that the payment be "made according to ordinary business terms." 11 U.S.C. § 547(c)(2)(C). The record shows that this payment was for invoices more than 180 days old. The district court found that the industry standard for payment of invoices was 120 days. Therefore, this issue turns on the sixty-day difference between the industry standard and the actual payment date.

In In re Gulf City Seafoods, Inc., this Court adopted an "objective test" for determining when a credit arrangement is within the ordinary course of business. 296 F.3d 363, 367-68 (5th Cir. 2002). "[T]he question must be resolved by consideration of the practices in the industry—not by the parties dealings with each other." Id. at 369. This Court was careful to ensure that the test did not "place businessmen in a straightjacket" by enforcing "strict conformity" to a standard or requiring "identical" credit

7The court stated that the parties "admitted" that this was the correct standard. The Trustee, however, disputes this standard and asserts that he never made such an admission. Whether or not the Trustee ever admitted the standard was 120 days is not significant here. No fact issue was created as the only summary judgment evidence presented with respect to this issue was that the standard was 120 days.
arrangements. Id. at 368. Instead, the ordinary business term "sets an outer boundary to the parties' practices" presenting the question of "whether a particular arrangement is so out of line with what others do that it fails" to be ordinary. Id. at 369.

The district court found that although the GeoResources payment was "outside the industry standard, [it] reflected historical relations between GeoResources and Ambar." The district court's analysis contradicts the test outlined in Gulf City Seafoods. According to the teachings of Gulf City Seafoods, the "historical relations" between GeoResources and Ambar should not be the focus of an objective inquiry. The Appellees argue that the payment still satisfies the "ordinary business" requirement, pointing to cases that have held that late payments are not per se "unordinary." See In re Grand Chevrolet, Inc., 25 F.3d 728, 732 (9th Cir. 1994); Lovett v. St. Johnsbury Trucking, 931 F.2d 494, 497 (8th Cir. 1991); In re Yurika Foods Corp., 888 F.2d 42, 44 (6th Cir. 1989).

The Gulf City Seafoods test allows for some late payments, as seen by its language that warns against enforcing "strict conformity" or requiring "identical" transactions. Gulf City Seafoods, 296 F.3d at 368. The question under Gulf City Seafoods becomes whether the sixty-day delay fails to be in the ordinary course of business because it is "so out of line with what others do." Id. at 369. The GeoResources payment was approximately sixty days late according to its own witnesses. The 180 days it took to
pay GeoResources is 150 percent of the industry standard. The
Trustee challenges the accuracy of the "120 day" figure, suggesting
that in practice it is much shorter. Even under the "120 day"
standard, the payment to GeoResources is significantly out of line
with what others do. The delay in payment here cannot be deemed
ordinary. For these reasons, it fails to be in the ordinary course
of business and therefore is a voidable preference.

VI. CONCLUSION

The district court did not err in its holding that Ramba had
no interest in the property transferred during the Patterson
transaction. For that reason, the court's judgment that the
indirect transfers did not constitute voidable preferences is
AFFIRMED. The district court did err in its determination that a
direct transfer to GeoResources was made in the ordinary course of
business. For that reason, we VACATE the court's judgment that the
direct transfer did not constitute a voidable preference and REMAND
for a decision consistent with this opinion.
CHAPTER 8
THE TRUSTEE’S POWER TO AVOID FRAUDULENT TRANSFERS

Fraudulent transfer law is old. The precursor to our modern fraudulent conveyances law dates back to the Statute of Elizabeth, enacted in England in the 16th Century. It was designed to protect creditors against debtors that would thwart collection efforts by giving away their property with the hopes of having it reconveyed after discouraged creditors gave up on collecting their claims. Case law history dating back to the 17th Century continues to be relevant. Indeed, current statutes can best be understood as crystallizing a lot of this long case-law history.

Today in the United States, every state has its own fraudulent conveyance law, which is applicable outside of bankruptcy as well as in bankruptcy. In addition, the Bankruptcy Code contains its own fraudulent conveyance law, codified in §548 of the Bankruptcy Code, which applies only in bankruptcy cases. The Uniform Fraudulent Transfer Act, (UFTA) is the applicable state fraudulent conveyance law of all but a few states. New York is the most important exception. The UFTA in many respects parallels §548, although the two are not identical. The remaining states retain the old Uniform Fraudulent Conveyance Act (UFCA).

The DIP essentially must show the following elements in a fraudulent conveyance action under §548:

1. a transfer, either voluntary or involuntary, of the debtor’s property or an interest therein (including the incurring of an obligation by the debtor and specifically including any transfer to or obligation incurred for the benefit of an insider under an employment contract);

2. made (or incurred) within two years before the date of the filing of the bankruptcy petition, and either

   (a) made (or incurred) with actual intent to hinder, delay, or defraud a creditor of the debtor (sometimes referred to as “actual fraud”), or

   (b) for which the debtor received less than reasonably equivalent value, and (i) the debtor was insolvent when the transfer was made (or obligation incurred) or was rendered insolvent hereby, or (ii) the debtor was engaged (or was about to become engaged) in a business for which the debtor’s remaining property represented an unreasonably small capital, or (iii) the debtor intended to incur (or believed he or she would incur) debts beyond his or her ability to repay as they matured (sometimes referred to as “constructive fraud”) or (iv) the debtor made the transfer or incurred the obligation to or for the benefit of an insider, under an employment contract, out of the ordinary course of business.

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1 Even more so in dog years!
Avoidance actions must be commenced under §548 before the later of two years after the entry of the order for relief (the date of the bankruptcy filing in voluntary cases) or one year after a trustee is appointed, if the appointment occurs before the expiration of the original two-year period.

Bankruptcy Rule 7001(2) requires the Plaintiff to bring an avoidance cause of action as an adversary proceeding. Plaintiff has the burden of making a *prima facie* case. Insolvency must be proven by the plaintiff; unlike in a preference action insolvency is not presumed. The standard of proof is preponderance of the evidence; intent to defraud, however, must be proven by clear and convincing evidence.

*Actual Intent vs. Reasonably Equivalent Value*

As indicated above, the DIP has the ability to avoid two different kinds of transfers: (1) transfers made with actual fraud (under §548(a)(1)(A)), or (2) transfers that involve constructive fraud (§548(a)(1)(B)). The distinction between the two is important. It is important in practice, because the *prima facie* showing required for each type of case is different. It is important in principle because it exhibits the different policies that underlie fraudulent transfer law.

The DIP is free to proceed under either prong of the fraudulent conveyance law. Thus, if the trustee can show insolvency and less than reasonably equivalent value, then he doesn’t have to show actual intent. For example, if the debtor gives away any of his property while he is insolvent, the trustee may avoid the transfer without any showing of intent. Alternatively, if the DIP can show that the debtor intended to hinder, delay or defraud, then he may avoid the transaction without any showing as to solvency.

The DIP is perfectly free to “plead in the alternative,” and there are cases where classes of fraudulent conveyance overlap: a debtor who gives away property while insolvent may well have the intent to hinder, delay or defraud creditors. Moreover, there may be a fine line between “intend[ing] to incur debts beyond his ability to pay” and “actual intent to hinder, delay, or defraud” a creditor.

*What Is a Transfer?*

So far, we have spoken of “transfers,” but we have not defined transfers. Of course, a conveyance of real or personal property can be a “transfer” and that is the most common case. For example, a deed to real property or a payment of cash is a transfer. But there are less obvious sorts of “transfers” as well. For example, granting a release or waiving of claims may be a transfer. Terminating a license could be a transfer. And some courts have held that making a tax election that results in a loss of valuable tax attributes constitutes a transfer. Thus, it makes sense to think broadly when considering what may constitute a transfer for purposes of fraudulent conveyance analysis—anything that results in a loss of value to the transferor, whether intentionally or not, may qualify.

In fact the Bankruptcy Code’s definition is more extensive than just transfers. It says the DIP “may avoid any transfer of an interest of the debtor in property.” But then it adds: “…or any
obligation incurred.” So a promise to transfer money or property may be avoidable, just as much as a transfer itself.

_Proving Intent_

It is usually difficult to find good, non-circumstantial evidence of “actual intent to hinder, delay or defraud.” People do not tend to admit such evil intent and other “hard evidence” of intent is hard to come by. Recognizing this, the UFTA includes a list of conditions or events that are suggestive of fraudulent intent. These are referred to as “badges of fraud.” UFTA §4(b) provides that “in determining actual intent under subsection (a)(1), consideration may be given, among other factors, to whether:

1. the transfer or obligation was to an insider;
2. the debtor retained possession or control of the property transferred after the transfer;
3. the transfer or obligation was disclosed or concealed;
4. before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
5. the transfer was of substantially all the debtor’s assets;
6. the debtor absconded;
7. the debtor removed or concealed assets;
8. the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
9. the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
10. the transfer occurred shortly before or shortly after a substantial debt was incurred; and
11. the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

And while these factors are not specifically included in §548, many judges consider them in fraudulent transfer actions under the Bankruptcy Code, as well as under the UFTA. The “badges of fraud” point to an important conceptual difficulty in fraudulent transfer law. That is, we are talking about “actual” intent. Yet by including the badges of fraud, the drafters implicitly concede that we rarely know the transferor’s actual intent: in most cases the best we can do is to infer the transferor’s intent from some outward signs.
Good Faith Transferees and Charitable Contributions

A transferee who deals at arm’s length with his transferor may be protected by a “good faith transferee rule.” Specifically, §548(c) provides that a transferee who takes for value and in good faith has a lien on the property transferred (or may retain property transferred) to the extent of the value he gave for the transfer.

For example, a good faith purchaser buys a house for $300,000. The Seller then files bankruptcy and sues the Buyer under §548 to avoid the sale as a fraudulent conveyance, arguing that Seller was insolvent at the time of the sale and that the house was actually worth $1 million. The transaction will be avoided because the Seller did not receive reasonably equivalent value, but the Buyer will retain a lien on the house, after it is reconveyed to the Seller’s estate, to secure its $300,000 purchase price. (If the Buyer made improvements to the house before he reconveyed it, she may also have a lien to secure the value of the improvements, pursuant to §550(e)).

Good faith requires an arm’s length transaction and the following three factors:

- a belief in the propriety of the actions in question;
- no intent to unconscionably disadvantage others; and
- no intent to, or awareness that the activities in question will hinder, delay or defraud others.

Lienors and obligees, as well as good faith purchasers may be protected under this defense. Knowledge of the transferor’s insolvency may prevent an assertion of good faith.

Another important exception relates to the case of charitable contributions. A charitable contribution would seem to be a gift, and if the debtor makes the charitable contribution while insolvent, you might think it would be avoidable under the “constructive fraud” rule. Not necessarily so per §548(a)(2), which insulates certain charitable contributions from fraudulent transfer attack. But note that it does not exempt charitable contributions made with actual intent to hinder, delay or defraud creditors.

Avoidance of Transfers to Asset Protect Trust

In reaction to the growing acceptance and legality of self-settled spend thrift trusts even in American jurisdictions, the Code provides for avoidance of transfers made within ten years of the petition date. See §548(e). To avoid the transfer, the DIP must show: (1) a transfer to a self-settled trust or similar device, (2) by the debtor, (3) the debtor is the beneficiary of the trust or other device, and (4) actual intent to hinder, delay, or defraud pre- or post-transfer creditors. By limiting avoidance to cases where actual, not constructive, intent to hinder, delay or defraud can be shown, this provision’s bark may be louder than its bite.
"Strong Arm" Avoidance Under Section 544(b)

Aside from §548, there is a wholly separate line of attack for the DIP trying to avoid a fraudulent transfer. This is §544(b) of the Code, which provides that the DIP may generally avoid a transfer “that is voidable under applicable law by a creditor holding an unsecured claim.” This means that the trustee may look to nonbankruptcy law (usually “state” law) and deploy any avoiding power that he finds there. The most common use of §544(b) is to give the trustee a right of action under state fraudulent transfer law—the UFTA or UFCA. These are most often useful to the DIP because of the longer reach-back period available under state law. As noted above, under §548 a DIP may avoid a fraudulent transfer only if it took place within two years prior to the petition date. However, depending on the state, the reach-back period under state law may be from two to six years.

There are occasionally other uses that a DIP can make of state fraudulent conveyance law—claims that exist under state law but not under §548. For example, under the UFTA a transfer by an insolvent debtor to an insider who knew of the insolvency, on account of a debt owed to the insider, may be avoidable, even though it would (absent actual fraud) not be avoidable under §548, because under §548 “value” includes the satisfaction of an antecedent debt. This case may not come up every day, but it illustrates an important point: when considering a fraudulent conveyance action, the DIP should review the applicable state statute to determine what claims may be available.
APPENDIX 8(a)
IN RE FRUEHAUF TRAILER CORPORATION

444 F.3d 203 (3rd Cir. 2006)

In this appeal we consider again the meaning and scope of the Bankruptcy Code’s fraudulent transfer provisions in 11 U.S.C. §548(a)(1). In particular, we review the District Court’s determinations that: (1) a debtor’s right to a surplus generated by a pension plan is a property interest; (2) an amendment to that pension plan that irrevocably decreases the surplus is a transfer of the property interest; and (3) the value surrendered and the value gained as a result of the transfer need not be precisely calculated in this instance in order to conclude that they are not reasonably equivalent. We also review the District Court’s assignment of the burden of proof. For the reasons that follow, we affirm.

I. Facts and Procedural Background

A. Fruehauf’s Financial Problems

Fruehauf Trailer Corporation (“Fruehauf” or the “Company”), a Delaware corporation, operated facilities throughout the United States that designed, manufactured, sold, distributed, and serviced truck trailers and related parts. Fruehauf expanded its business rapidly in the 1980s, leading to overextension of capital and related cash flow problems. By the early 1990s Fruehauf’s long-term liabilities (such as employee health care and pensions) exceeded revenues, and by 1996 Fruehauf had a negative net worth of approximately $120 million. The Company sought to address this problem by reducing its work force to approximately 2,000 employees (about half of them union members), closing facilities, and selling assets. It also froze the calculation of retirement benefits for all employees at 1991 salary levels.

In the early 1990s the Fruehauf Board of Directors (the “Board”) began exploring a possible sale of the Company, in whole or in part. In 1995 Fruehauf entered into contracts with several of its top executives that would pay them significant benefits if the Company or its assets were sold. These contracts sought to ensure that top executives would remain with the Company until the sale, as the benefits would not accrue to the beneficiaries unless they were still employed by Fruehauf at that time. In 1996, Fruehauf also instituted a Key Employee Retention Program (“KERP”) under which it agreed to pay bonuses totaling $1.3 million to forty key employees if they agreed to remain until the sale or March 31, 1997, whichever came first.

B. The Emergency Board Meeting

Fruehauf continued to have financial difficulties, and on Sept. 19, 1996, with the Company lacking sufficient cash to meet its payroll and other operating expenses, its Board held an emergency meeting. Although the parties dispute what was considered at this meeting, the District Court concluded that the Board and Fruehauf’s outside counsel discussed three things. First, they considered the possibility of a Chapter 11 bankruptcy filing. Second, they discussed a modified retention plan that would distribute immediate cash payments to twelve of the KERP...
beneficiaries if they agreed to remain with the Company until at least March 1, 1997 (the “KERP modification”). Finally, they discussed an amendment (known as the “Third Amendment”) to the Company’s pension plan.¹

The Third Amendment was drafted by Fruehauf’s outside counsel and reviewed by Geraldine Tigner (Fruehauf’s Vice President of Human Resources) and Greg Fehr (a senior Fruehauf executive), both of whom were members of the Company’s Pension Administration Committee. Limited to 400 Fruehauf employees (almost all of them managers or executives, and none union members or non-salaried workers), it provided two things. First, it lifted the 1991 benefit freeze for those employees who were vested in the pension plan and calculated benefits based on 1996 salaries (hereafter the “Pension Thaw Provision”). Second, it granted all covered employees a cash contribution to their pension account equal to 5 percent of annual salary plus 8 percent annual interest (hereafter the “Cash Benefit Provision”) if they were employed by the Company or its successor on, or were laid off prior to, March 31, 1997. Because the Cash Benefit Provision was available to all employees covered by the Third Amendment, it included even those not vested in the pension plan. Notably, Tigner and Fehr, who were the only Fruehauf executives to review the Third Amendment and who were also beneficiaries of the KERP, stood to reap substantial benefits from its adoption. Fehr’s pension benefits increased by 470 percent, while Tigner’s benefits increased by 200 percent.² Fruehauf later calculated the cost of the Third Amendment as $2.4 million.

The source of funding for the Third Amendment was a surplus on the “union side” of Fruehauf’s pension plan, i.e., the funds designated to pay benefits for union members exceeded the cost of those benefits. Those surplus funds would otherwise revert to the Company after benefits were paid.

With this backdrop, the Board approved the Third Amendment at the Sept. 19, 1996 emergency meeting. It became effective on Oct. 4, 1996.

C. Proceedings in the Bankruptcy Court

On Oct. 7, 1996, Fruehauf filed for Chapter 11 bankruptcy protection in the District of Delaware. Fruehauf’s debts and liabilities totaled over $12 billion at this time, and it was liquidated to satisfy its creditors. Several purchasers bought Fruehauf’s assets in the United States and Europe. The most significant purchaser was Wabash National, L.P. (“Wabash”), which bought two manufacturing plants and 31 distribution centers in the United States for $55 million. Although the asset purchase agreement between Fruehauf and Wabash did not contain a commitment on Wabash’s part to retain any of Fruehauf’s employees after the sale, it

¹ The pension plan is a qualified plan under the Employee Retirement Income Security Act of 1974 (“ERISA”), as amended, 29 U.S.C. §1001 et seq. It is a nominal party to this appeal.

² The other members of the Pension Administration Committee also realized substantial gains. The pension plan’s actuary testified that Kenneth Minor received a 455 percent increase in benefits and Joseph Damiano received a 330 percent increase. Derek Nagle, the CEO of Fruehauf shortly before the Company went into Chapter 11, received an increase of nearly 200 percent.
did rehire approximately 475 unionized employees. Fruehauf’s remaining assets were placed in a liquidation trust (known as the “End of the Road Trust”), and the pension plan was taken over by appellee Pension Transfer Corporation (“PTC”), a subsidiary of the Trust.

During the course of the bankruptcy case, Fruehauf sought and received the Bankruptcy Court’s approval of payments to key employees who had participated in the KERP. It did not seek Bankruptcy Court approval of disbursements under the Third Amendment.

On Jan. 20, 1998, Fruehauf (as debtor-in-possession) began an adversary proceeding in the Bankruptcy Court against the pension plan, alleging that payouts under the Third Amendment would result in a fraudulent transfer in violation of 11 U.S.C. §548. The Bankruptcy Court granted Fruehauf’s request for a preliminary injunction against the pension plan and enjoined the plan from distributing payments under the Third Amendment. On Oct. 27, 1999 the Bankruptcy Court approved Fruehauf’s amended reorganization plan and substituted PTC as the administrator of the pension plan. PTC thus replaced Fruehauf in the adversary action, which was transferred to the District Court.

D. Proceedings in the District Court

On April 3, 2001, the District Court granted PTC’s motion to reclassify the pension plan as a nominal defendant and add the individual beneficiaries of the Third Amendment as defendants. On May 1, 2002, the Court certified a mandatory defendant class, pursuant to Federal Rule of Civil Procedure 23, consisting of all beneficiaries of the Third Amendment (the “Class Defendants”). The Court held a three-day bench trial in March 2004.

(1) Testimony

At trial, PTC called three witnesses to testify: Chriss Street, an independent director of Fruehauf and trustee of the End of the Road Trust; Lawrence Wattenberg, the actuary for the Fruehauf pension plan; and Irving Becker, the head of the Compensation Advisory Services Group of the accounting firm KPMG, who testified as an expert on employment compensation in general and KERPs in particular.

Street testified that he and Worth Frederick, the other independent director on the Fruehauf Board, strenuously objected to the KERP modification at the Sept. 19, 1996 meeting because it prepaid the KERP bonuses of many top executives at a time when it was difficult for those executives to find work elsewhere in the industry (resulting in little concern they would leave the Company). He also testified that the Board was not given any substantive information about the Third Amendment and that it was presented at the Board meeting as an “administrative change” that would have no cash effect on the Company. Moreover, Street testified that the Third Amendment was never presented as a part of the KERP or for the purpose of employee retention. Although Street and Frederick abstained, the Board approved both the KERP modification and the Third Amendment. Later, Street and Frederick objected to the minutes of the meeting, which stated that the Third Amendment was part of the KERP and that both of them had voted in favor. The minutes were only corrected after the Company entered Chapter 11 and Street and Frederick became the sole remaining Board members.
Wattenberg testified that his review of the Third Amendment revealed that, on average, it nearly doubled the pension benefits of non-union salaried employees, and that “certain senior executives increased their benefits by 400 to 500 percent.” He also calculated that, as of September 2003, the cost of the Third Amendment rose to over $4.4 million. On cross-examination, however, he admitted that he did not calculate how much of a surplus existed in September 1996 or how much money Fruehauf might have recovered without the Third Amendment.

Becker testified that the Third Amendment was not part of the KERP or otherwise for the purpose of employee retention. He noted that, in his experience, he had never seen pension benefits used as part of a KERP, and that the “reasonable norm” for KERPs would include payments to key employees of between 0.4 percent and 0.5 percent of revenue to retain them for twelve to eighteen months. He calculated that the Fruehauf KERP (apart from the Third Amendment) was at the “high end of those norms” because it paid about 0.3 percent of revenue to retain key employees for only eight months. If the Third Amendment was viewed as part of an employee retention plan, however, Fruehauf’s plan (the KERP plus the Third Amendment) would cost 0.88 percent of annual revenue—which, in Becker’s expert opinion, was “not reasonable and did not provide additional value to Fruehauf.”

The Class Defendants called two witnesses to testify: Geraldine Tigner (as noted above, Fruehauf’s Vice President of Human Resources and one of the Fruehauf executives to review and benefit from the Third Amendment) and Mark Holden, Wabash’s Chief Financial Officer. Tigner testified that the Pension Thaw Provision of the Third Amendment was designed to improve morale and the Cash Benefit Provision was intended to benefit those who were not yet vested in the pension plan and thus could not benefit from the Pension Thaw Provision. She testified that both provisions were meant to help retain personnel while Fruehauf was searching for a buyer, and that this understanding was communicated in an Oct. 9, 1996 letter she sent to Fruehauf’s salaried employees, which stated that the Third Amendment was intended to “reward our loyal employees whose dedication will provide the basis for a successful transition.”

On cross-examination, however, Tigner conceded that the Pension Thaw Provision was intended to bring the pension plan up to date and take into account salaried employees’ past service. She further testified that the Third Amendment was not made applicable to unionized employees because their collective bargaining agreements prohibited unilateral changes in benefits. She did not, however, ask the unions if their members wanted a pension increase despite the fact that the surplus used to pay for the Third Amendment had been generated on the union side of the pension plan.

Holden testified that Wabash was interested in purchasing Fruehauf “as an ongoing business” and was “very concerned about the flight risk of Management within those businesses as well as the people underneath Management.” He further testified, however, that he was “not sure [Wabash] paid more money” for Fruehauf because it was an ongoing business, and agreed with plaintiff’s counsel’s characterization of the asset purchase agreement as assigning no value to Fruehauf’s employees. Holden also stated that Wabash expressly refused to make any promises to hire any of Fruehauf’s employees.
(2) **District Court’s Decision**

On Jan. 7, 2005, the District Court issued a comprehensive opinion finding that the Third Amendment was a fraudulent transfer under 11 U.S.C. §548. The Court determined, as a factual matter, that the Amendment was never presented to the Board as part of the KERP, and even if it had been, the total KERP would have constituted 0.88 percent of annual revenue, which would have “exceeded the amount that a reasonable Company in Fruehauf’s position would spend to retain employees.” The Court also found that the Class Defendants “offered no evidence that Wabash paid more money because the assets it purchased were ongoing operations.”

Turning to the legal question of whether the Third Amendment was a fraudulent transfer, the District Court analyzed the factors set forth in §548. It concluded that Fruehauf had a future ownership interest in any surplus generated by the pension plan, and that the Third Amendment irrevocably transferred this interest to the Class Defendants by allocating a portion of the surplus to increased pension benefits for non-union salaried employees. The Court agreed with the Class Defendants that PTC failed to prove that Fruehauf received no value from this transfer, but nonetheless concluded that the value was not “reasonably equivalent” to the costs of the transfer. Specifically, the Court rejected the Class Defendants’ contention that the Third Amendment helped retain key personnel and assure that Fruehauf remained an ongoing business so that it was easier to sell. It concluded that “Fruehauf received considerably less than the cost of the Third Amendment” because, coupled with the KERP, the Class Defendants’ purported retention goals cost Fruehauf “twice the norm” and the Class Defendants failed to rebut adequately PTC’s evidence that the $2.4 million projected cost of the Third Amendment did not help assure the $55 million Wabash purchase. Indeed, the Court noted that Holden “did not testify with certainty that Wabash would not have purchased the Fruehauf assets if they were not ongoing concerns,” and Tigner “was not able to offer factual support for the conclusion that the Third Amendment had the effect of retaining Fruehauf employees.” The District Court therefore determined that payments under the Third Amendment would be a fraudulent transfer that PTC could avoid.

**E. Appeal**

The Class Defendants raise three issues on appeal. First, they contend that the District Court erred in determining that PTC had a cognizable property interest in the pension plan surplus that was transferred as a result of the Third Amendment. Second, they argue that the Court erred in not applying the correct test for determining whether a transfer is fraudulent, and that error is not harmless because PTC did not satisfy its burden of proving the value surrendered and received. Third, they assert that the Court erred in assigning the burden of proof.\(^3\)

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\(^3\) The District Court had subject matter jurisdiction over this case pursuant to 28 U.S.C. §1334, as it is an adversary proceeding arising under Title 11 of the United States Code, and we have jurisdiction over the appeal pursuant to 28 U.S.C. §1291.
II. Standard of Review

In considering final orders of courts in bankruptcy cases, we review findings of fact for clear error and exercise plenary review over questions of law. In re Schick, 418 F.3d 321, 323 (3d Cir. 2005). Factual findings may only be overturned if they are “completely devoid of a credible evidentiary basis or bear[] no rational relationship to the supporting data.” Citicorp Venture Capital, Ltd. v. Comm. of Creditors, 323 F.3d 228, 232 (3d Cir. 2003) (citation and internal quotation marks omitted; alteration in original). The District Court’s allocation of the burden of proof is a question of law subject to plenary review. Polselli v. Nationwide Mut. Fire Ins. Co., 23 F.3d 747, 750 (3d Cir. 1994).

III. Analysis

Section 548(a)(1) allows a trustee to avoid any transfer of the debtor’s interest in property made within one year before the filing of a bankruptcy petition if the transfer was the result of actual or constructive fraud. This provision “aims to make available to creditors those assets of the debtor that are rightfully a part of the bankruptcy estate, even if they have been transferred away.” In re PWS Holding Corp., 303 F.3d 308, 313 (3d Cir. 2002).

“Actual” fraud is prohibited by §548(a)(1)(A), which allows a trustee to avoid a transfer made “with actual intent to hinder, delay, or defraud any entity to which the debtor was or became…indebted.” “Constructive” fraud, the subject of this appeal, is prohibited by

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4 At the time Fruehauf instituted the adversary proceeding at issue in this case, 11 U.S.C. §548(a)(1) provided:

The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor’s ability to pay as such debts matured.

On April 20, 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), Pub. L. 109-8, 119 Stat. 23, which amended §548, inter alia, to allow avoidance of fraudulent transfers made within two years of the filing of a bankruptcy petition and to strengthen prohibitions on insider employment contracts not made in the ordinary course of business. See BAPCPA §1402, 119 Stat. at 214. Because these provisions are not applicable to cases begun before the passage of the BAPCPA, see id. §1406(b), 119 Stat. at 215-16, they are not relevant to this appeal.
§548(a)(1)(B); although it contains no intent requirement, fraud on the creditors is presumed once the plaintiff establishes the requisite elements. *Mellon Bank, N.A. v. Metro Communications, Inc.*, 945 F.2d 635, 645 (3d Cir. 1991) (hereafter “Metro Communications”). Those elements are: (1) the debtor had an interest in property; (2) a transfer of that interest occurred within one year of the bankruptcy filing; (3) the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer; and (4) the transfer resulted in no value for the debtor or the value received was not “reasonably equivalent” to the value of the relinquished property interest. See 11 U.S.C. §548(a)(1); *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 535, 114 S. Ct. 1757, 128 L. Ed. 2d 556 (1994). The party bringing the fraudulent conveyance action bears the burden of proving each of these elements by a preponderance of the evidence. See *Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L. (In re R.M.L.),* 92 F.3d 139, 144 (3d Cir. 1996) (hereafter “R.M.L.”). There is no dispute here that the alleged transfer was made within one year of the filing of Fruehauf’s bankruptcy petition and that Fruehauf was insolvent at that time. Therefore, the relevant issues are whether PTC satisfied its burden of proving that Fruehauf had a property interest, that the interest was transferred, and that the gains and losses as a result of the transfer were not of reasonably equivalent value.

### A. Property Interest

The Bankruptcy Code defines property interests broadly, encompassing “all legal or equitable interests of the debtor in property.” 11 U.S.C. §541(a)(1). The Supreme Court has noted that “the main thrust of [the Bankruptcy Code] is to secure for creditors everything of value the bankrupt may possess in alienable or levi
able form when he files his petition. To this end the term ‘property’ has been construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed.” *Segal v. Rochelle*, 382 U.S. 375, 379, 86 S. Ct. 511, 15 L. Ed. 2d 428 (1966). Property of the estate “includes all interests, such as…contingent interests and future interests, whether or not transferable by the debtor.” *In re Prudential Lines, Inc.*, 928 F.2d 565, 572 (2d Cir. 1991) (quoting H.R. Rep. No. 95-595, 175-76 (1978)). It is also well established that “the mere ‘opportunity’ to receive an economic benefit in the future” is property with value under the Bankruptcy Code. *R.M.L.*, 92 F.3d at 148.

Under ERISA, an employer who sponsors a qualifying retirement plan is entitled to recoup any surplus upon termination of the plan. See 29 U.S.C. §1344(d)(1); *Ashenbaugh v. Crucible, Inc.*, 1975 Salaried Retirement Plan, 854 F.2d 1516, 1523 n.9 (3d Cir. 1988). This recoupment right is a transferable property interest. See, e.g., *Creasy v. Coleman Furniture Corp.*, 763 F.2d 656, 662 (4th Cir. 1985) (“Under the terms of the contract any left-over assets of the [pension] fund were to be paid over to the Company…The excess, if any, would be property of the debtor’s estate. The trustee acquires the rights that the corporate bankrupt possessed; therefore, the excess funds would be an asset in the bankrupt’s estate.”); *In re Wingspread Corp.*, 155 B.R. 658, 664 (Bankr. S.D.N.Y. 1993) (“Although the right to recover [the surplus from an ERISA-qualified retirement plan] is a future estate, the reversion itself is a present, vested estate. As a result, the employer’s reversionary interest falls within the broad reach of §541(a) of the Bankruptcy Code and is considered property of the debtor’s estate. Not only does the employer have a present interest in those reversionary assets, but that reversionary interest is transferable and alienable.” (internal citations omitted)). In this context, the District Court was correct that
Fruehauf’s potential future recoupment of the surplus from its pension plan was a transferable property interest for purposes of §548.

B. Transfer

The District Court also correctly found that a property interest under the Third Amendment was transferred. The Bankruptcy Code defines “transfer” in the broadest possible terms: “each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or an interest in property.” 11 U.S.C. §101(54)(D). Under ERISA’s “anti-cutback” provision, benefits accrued in a qualified plan are irrevocable; an administrator or sponsor may not decrease them once they are granted. See 29 U.S.C. §1054(g)(1); Central Laborers’ Pension Fund v. Heinz, 541 U.S. 739, 743-44, 124 S. Ct. 2230, 159 L. Ed. 2d 46 (2004); see also Hoover v. Cumberland, Md. Area Teamsters Pension Fund, 756 F.2d 977, 981 (3d Cir. 1985) (defining “accrued benefit” as “an annual benefit commencing at normal retirement age” (quoting 29 U.S.C. §1002(23)(A))). There is no question here that, upon ratification of the Third Amendment by the Board, the benefits of the Pension Thaw and Cash Benefit Provisions “accrued” to the Class Defendants. Because ERISA prohibited Fruehauf from decreasing or revoking those benefits, the District Court correctly concluded that the irrevocable allocation of part of the Company’s future interest in the pension plan’s surplus in the form of increased benefits was a “transfer” for purposes of the Bankruptcy Code.

C. Reasonably Equivalent Value

The Class Defendants concentrate most of their attention on the District Court’s determination that the value gained by Fruehauf from the Third Amendment was not “reasonably equivalent” to the value surrendered. Specifically, they contend that the District Court erred in finding that PTC satisfied its burden of proof even though it did not conclusively establish either the value that Fruehauf gave up as a result of its commitment to fund the Third Amendment or the value that Fruehauf gained. This, the Class Defendants assert, runs afoul of Metro Communications’ calculation requirement.

(1) Value

Before considering a plaintiff’s obligation to define with precision the value surrendered and gained as a result of a transfer, we need to understand the general structure of the reasonably equivalent value analysis. We have interpreted “value” to include “any benefit[…][whether direct or indirect.” R.M.L., 92 F.3d at 150. As noted above, “the mere ‘opportunity’ to receive an economic benefit in the future constitutes ‘value’ under the [Bankruptcy] Code.” Id. at 148. Thus, Fruehauf gave up something of value when the Board ratified the Third Amendment.

The next question is whether the debtor received any value from the transfer. See id. at 149-50. Although, as explained below, the “totality of the circumstances” is considered in determining whether the values surrendered and gained as a result of a transfer are reasonably equivalent, a court should not consider the “totality of the circumstances” in evaluating the threshold question of whether any value was received at all. Id. at 150. Rather, a court must consider whether, “based on the circumstances that existed at the time” of the transfer, it was “legitimate and reasonable” to expect some value accruing to the debtor. Id. at 152 (internal
quotation marks and emphasis omitted). Although PTC argued before the District Court that the Third Amendment did not confer any value on Fruehauf, the Court disagreed because PTC had not excluded the possibility that “the Third Amendment [was] effective in retaining the services of at least one Fruehauf employee.” PTC does not challenge this determination on appeal.

If a court determines that the debtor gained at least some value as a result of the transfer, what follows is a comparison: whether the debtor got roughly the value it gave. See 11 U.S.C. §548(a)(1)(A); Metro Communications, 945 F.2d at 647. In conducting this factual analysis, a court does look to the “totality of the circumstances,” including (1) the “fair market value” of the benefit received as a result of the transfer, (2) “the existence of an arm’s-length relationship between the debtor and the transferee,” and (3) the transferee’s good faith. R.M.L., 92 F.3d at 148-49, 153.

(2) Calculation Requirements

As noted above, “the value of consideration received must be compared to the value given by the debtor.” Metro Communications, 945 F.2d at 648. Calculating “direct” benefits (such as an investment of cash that yields a cash return) is typically easy, but becomes more difficult when benefits are “indirect.” See R.M.L., 92 F.3d at 148. Nonetheless, “these indirect economic benefits must be measured and then compared to the obligations that the bankrupt incurred.” Metro Communications, 945 F.2d at 647 see In re Richards & Conover Steel Co., 267 B.R. 602, 612 (B.A.P. 8th Cir. 2001) (“In deciding whether value has been transferred the court must examine all aspects of the transaction and carefully measure the value of all benefits and burdens to the debtor, direct or indirect” (citation and internal quotation marks omitted)); In re BCP Mgmt., Inc., 320 B.R. 265, 280 (Bankr. D. Del. 2005) (same, citing Metro Communications).

Metro Communications does not, however, require a precise calculation of value in all circumstances. There, Mellon Bank (“Mellon”) provided Total Communications Systems (“TCS”) with a $1.85 million loan to acquire Metro Communications, Inc. (“Metro”). Metro guaranteed TCS’s debt to Mellon and, to secure that guaranty, it granted Mellon a security interest in its assets. As a result of this transfer, Metro (as part of TCS) was eligible for substantial advances of credit and had the opportunity to “synergize” its operations with those of TCS. Yet Metro went bankrupt shortly thereafter, and the unsecured creditors’ committee argued that the security interest conferred no value on Metro because “Metro did not receive the proceeds of the acquisition loan, [and thus] did not receive any direct benefits from extending the guaranty and security interest collateralizing that guaranty.” Metro Communications, 945 F.2d at 646. In holding that the security interest was not a fraudulent transfer under §548, we noted:

The value…of the synergy obtained in the corporations’ affiliation and the value of obtaining the credit are difficult to quantify in dollars without the aid of expert witnesses. Regrettably, no such testimony was forthcoming in this case…

We do know that the assets of the guaranteeing corporations were sufficiently valuable to justify an immediate additional loan by Mellon to TCS of 2.3 million dollars and letters of credit for an additional 2.25 million dollars. These loans enabled Metro…immediately to achieve a very sharp rise in its broadcasting rights amounting to a grand total of $26,240,705. Although the
ability to obtain credit is the lifeblood of the commercial world and governmental operational survival, and the synergistic strength expected from the merger here no doubt had value, the Committee introduced no evidence to support its burden of showing that Metro received less than reasonably equivalent value in exchange for its guaranty and security interest. The Committee acted on the blind assumption that they had no value…

Id. at 647-48.

Our decision in R.M.L. clarified Metro Communications’ requirements. The R.M.L. debtor paid $390,000 in commitment fees to Mellon Bank for the chance to secure a loan of $53 million, but the loan was never made. Moreover, the agreement between the debtor and Mellon Bank provided that the commitment fees would be retained by Mellon “even if the loan did not close.” R.M.L., 92 F.3d at 143. In determining whether the commitment fees were a fraudulent transfer, we reiterated that “essential to a proper application of the totality of the circumstances test [in determining reasonably equivalent value] is a comparison between the value that was conferred and the fees [the debtor] paid.” Id. at 154. We “acknowledged that the measurement and comparison called for by [Metro Communications] is no easy task,” but “expressed no reservations about the bankruptcy courts’ ability to analyze such potential, intangible benefits.” Id. And yet, despite the Bankruptcy Court not calculating the actual value of the benefits that accrued to the debtor as a result of paying the commitment fees, we discerned no clear error in the Bankruptcy Court’s determination that “the chances of the loan closing were negligible,” and thus “whatever value was conferred” by the chance of securing the loan was “minimal” and “not reasonably equivalent to the fees [the debtor] paid.” Id. at 148, 153-54; see also Reily v. Kapila (In re Int’l Mgmt. Assoc.), 399 F.3d 1288, 1292 (11th Cir. 2005) (assuming, despite the lack of precise calculations in the record, that the value of stock received as a result of a transfer was obviously “less than [the] $100,000 [cost of the transfer] and in all probability was worthless”).

R.M.L. clarifies that Metro Communications did not establish a per se rule requiring a precise calculation of the cash value of intangible costs and benefits in every case, nor did it preclude all inferences regarding values surrendered and gained as a result of a transfer. Rather, we believe Metro Communications, in light of our subsequent holding in R.M.L., stands for two principles. First, in those cases where the plaintiff contends that a transfer resulted in no value to the debtor, the plaintiff must ordinarily prove that the calculated value of the benefit is zero. If no calculations are offered into evidence, and there is some evidence that the benefit conferred value, the plaintiff cannot satisfy its burden of proof. Second, where the value of an intangible benefit could equal or exceed the value surrendered by the debtor, precise calculations are essential to allow the court to determine equivalency properly.

But this general rule yields to common sense: in those cases where a court has sufficient evidence to conclude, based on a totality of the circumstances, that the benefits to the debtor are minimal and certainly not equivalent to the value of a substantial outlay of assets, the plaintiff

5 Such a rule comports with our observation in R.M.L. that it will be a “rare occasion[]” when “a debtor exchanges cash for intangibles that have no ‘value’ at the time of the transfer.” 92 F.3d at 149 n.3
need not prove the precise value of the benefit because such a calculation is unnecessary to the court’s analysis. Moreover, *R.M.L.* makes clear that the trier of fact’s ultimate determination of whether the values are reasonably equivalent is reviewed only for clear error, even if the court did not convert those values into precise cash quantities.

(3) **Application to this Case**

We therefore determine whether PTC failed to calculate the cash costs to Fruehauf of the Third Amendment and the cash value of the benefits to Fruehauf, and, if so, whether the District Court’s determination that these values were not “reasonably equivalent” is clearly erroneous. We conclude that the District Court committed no error, let alone clear error.

The Class Defendants contend, first, that the District Court erred in ruling that PTC satisfied its burden of proving what Fruehauf would have had to pay to fund the Third Amendment. The Court found, based on Fruehauf’s own calculation, that the projected cost of the Third Amendment was $2.4 million. At oral argument before us, the Class Defendants contended that the actual cost of the Amendment was less because the projected cost did not take into account variables such as changes in retirement age and shortened duration of the plan.

We conclude, however, that the District Court did not clearly err in relying on Fruehauf’s own calculation of the cost of the Third Amendment. For the reasons stated in Part III.D below, PTC did not need to disprove the Class Defendants’ assertions that Fruehauf’s calculations were inaccurate. Rather, the Class Defendants should have come forward with evidence that the cost of the plan had changed, and they did not. Moreover, we note that the pension plan actuary (Wattenberg) testified that, based on revised calculations in September 2003, the cost of the Third Amendment actually rose to over $4.4 million. In this context, the District Court had ample evidence to conclude that the cost to Fruehauf of funding the Third Amendment was at least $2.4 million, and since the Class Defendants did not provide evidence of a different amount, the Court’s finding was not clearly erroneous.

The Class Defendants contend this was error because, as the District Court stated, PTC did not sustain its burden of proving that the Third Amendment had no usefulness as an employee retention mechanism. Therefore, insofar as the Third Amendment helped Fruehauf retain key employees and maintain an ongoing business while the Company was looking for a buyer, the Class Defendants contend it was not a fraudulent transfer because it helped secure Wabash’s eventual purchase of Fruehauf’s ongoing business operations for $55 million. This, in the Class Defendants’ view, is easily “equivalent” to the projected $2.4 million cost of the Third Amendment.

The District Court found that Fruehauf accrued some benefit as a result of the Third Amendment, but did not place a dollar figure on that amount. It did find, however, that whatever the value was, it was “considerably less than the cost of the Third Amendment.” The Class Defendants contend this was error because, as the District Court stated, PTC did not sustain its burden of proving that the Third Amendment had no usefulness as an employee retention mechanism. Therefore, insofar as the Third Amendment helped Fruehauf retain key employees and maintain an ongoing business while the Company was looking for a buyer, the Class Defendants contend it was not a fraudulent transfer because it helped secure Wabash’s eventual purchase of Fruehauf’s ongoing business operations for $55 million. This, in the Class Defendants’ view, is easily “equivalent” to the projected $2.4 million cost of the Third Amendment.

The District Court held that the Third Amendment conferred some value on Fruehauf because it “may have been effective in retaining the services of at least one Fruehauf employee.” Nonetheless, the Court went on to conclude that the Third Amendment was never presented to the Board or the Bankruptcy Court as part of Fruehauf’s employee retention program, and even if it were part of that program, the combined cost of the Third Amendment and the KERP was
“twice the norm” of employee retention plans in other companies and “exceeded the amount necessary to retain employees.”

The Court also found that “the manner in which the Third Amendment was presented to Fruehauf’s Board of Directors for approval, and the fact that the Third Amendment’s sponsors stood to benefit significantly from its implementation,” strongly weighed in favor of finding that the Amendment did not confer reasonably equivalent value on Fruehauf. Though the District Court did not expressly refer to the totality of the circumstances test approved in R.M.L., its analysis closely tracks that test. Even if we accept the Class Defendants’ assertion that the Third Amendment was intended to retain employees, the fact that it and the KERP cost twice what an employee retention plan normally costs, in an industry with very few other jobs to which employees might go, tends to prove that Fruehauf did not pay fair market value for the benefit received. That the benefits inured substantially to corporate insiders, and the Amendment was reviewed by those who stood to gain between 200 percent and 500 percent increases in their pension benefits if it were approved, suggest that the transaction was not conducted at arm’s length. Moreover, funding the Third Amendment from the union-side pension plan surplus—without informing the unions or even raising with them the possibility of pension increases for their members (and therefore not benefitting those union employees)—coupled with the fact that the Third Amendment was presented to the Board, inaccurately, as an “administrative formality” that required no discussion nor a cash expenditure from Fruehauf, strongly suggest that the Third Amendment was not a “good faith” transaction.

Since the totality of the circumstances, based on record evidence, supports a finding that the value gained was not reasonably equivalent to the value lost (and therefore the finding is not clearly erroneous), did the District Court nonetheless err because the plaintiff did not prove the precise cash value of the benefit received? The answer in this case is plainly no. As explained above, our cases establish no rule so particular; indeed, such formalism would be at odds with §548, which merely requires that the plaintiff prove, by a preponderance of the evidence, that the value surrendered in the transfer was not reasonably equivalent to the value gained from the transfer. The District Court correctly found that although PTC did not prove that the Third Amendment conferred no value on Fruehauf, the value the Amendment did confer was largely redundant of the value conferred by the KERP and, based on the totality of the circumstances, the Third Amendment as an employee retention device was overpriced, not negotiated at arm’s length, accrued substantially to the benefit of corporate insiders, and was not implemented in good faith.

The conclusion from these findings is that, while the Third Amendment might have conferred some value on Fruehauf by influencing at least one employee to stay with the Company, it was not, on the whole, useful as an independent means of maintaining Fruehauf as an ongoing business prior to sale. Therefore, this case is not, as the Class Defendants contend in their brief, one where Fruehauf invested $2.4 million in its pension plan to maintain an ongoing business and safeguard a $55 million sale. As in R.M.L., PTC’s failure to present evidence of the precise cash value of the minimal benefit that did accrue to Fruehauf as a result of the Third Amendment is of no consequence.
D. Burden of Proof

The Class Defendants also contend that the District Court inappropriately assigned them the burden of proving that the values surrendered and gained as a result of the Third Amendment were reasonably equivalent. In particular, they cite the District Court’s observations that Tigner “was not able to offer factual support for the conclusion that the Third Amendment had the effect of retaining Fruehauf employees,” and that, even if she had offered that support, Wabash CFO Holden “did not testify with certainty that Wabash would not have purchased the Fruehauf assets if they were not ongoing concerns.” These statements by the Court, the Class Defendants argue, misplace what should be PTC’s burden of proof.

This argument is not convincing. The District Court stated several times that PTC had the burden of proof and the Class Defendants bore no burden, and we therefore doubt that the Court was confused on the proper allocation of the burden of proof. In any event, PTC offered testimony and other evidence that the Third Amendment was not a component of the employee retention plan. Even if it were, Wabash did not assign added value to Fruehauf as an ongoing business nor did Wabash value the existence of a continuing workforce (and indeed took steps to assure that Fruehauf’s employees would be terminated before the sale took place so that Wabash could hire workers as it saw fit). The Class Defendants argued the opposite: that the Third Amendment was intended to retain employees and maintain an ongoing business and that Wabash paid extra for Fruehauf because the latter was an ongoing business. The Class Defendants did not, however, present evidence in support of their contentions sufficient to convince the District Court that PTC had not met its burden of proof. As the First Circuit Court of Appeals has noted:

The Trustee undisputably has the burden of proving the transfers were fraudulent, and this burden never shifts to [the defendant]. But [a] court [should not] equate the burden of proof with the burden of production.

The burden of the issue and the duty of going forward with evidence are two very different things. The former remains on the party affirming a fact in support of his case, and does not change at any time throughout the trial. The latter may shift from side to side as the case progresses, according to the nature and strength of the proofs offered in support or denial of the main fact to be established.

9 Wigmore, Evidence §2487 (Chadbourn rev.1981)...Once the Trustee establishes his prima facie case, he need not affirmatively disprove every other potential theory.

In re Rowanoak Corp., 344 F.3d 126, 131-32 (1st Cir. 2003).

Here, the District Court did not clearly err in deciding that PTC satisfied its burden of proving its prima facie case (i.e., that PTC proved all the elements of a fraudulent transfer set forth in 11 U.S.C. §548), and thus it was incumbent on the Class Defendants to produce some evidence to rebut PTC’s proof. That the Class Defendants failed to do so makes affirming the District Court the only proper course.
CHAPTER 9
WHAT EVERY UNSECURED CREDITOR SHOULD KNOW ABOUT
CHAPTER 11

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

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

Steps to Take Immediately Upon Notice of a Chapter 11 Filing

A. First Day Hearings Can Impact Rights

As discussed in chapter 2, upon the filing of a debtor’s bankruptcy case, the Bankruptcy
Court will typically hear a series of motions filed by the DIP in which the DIP requests certain
authority that it is not automatically entitled to receive under the Bankruptcy Code. In almost all
cases, some of these motions include requests to treat certain creditors’ claims differently than
they might otherwise be treated by the Bankruptcy Code’s priority scheme.

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

Also usually included among the first-day motions is the DIP’s request to use cash
collateral and/or obtain DIP financing. Once approved, such financing orders typically have a
significant impact on the priority scheme for recovery in the bankruptcy case, as they usually
involve priming and replacement liens, intricate debt service requirements, and carve-outs for
specific types of claims. Chapter 11 of this book discusses chapter 11 financing.
Unsecured creditors and/or their advisors should read these motions to consider the potential impact on their rights. If appropriate, they should file an objection (or if there isn’t enough time to file something, show up at the hearing and object). If you don’t protect your rights, you may find that the game is half over just after it starts.

B. Obtaining Information About the Case

Upon the initial bankruptcy filing, the DIP is required to serve all known creditors with notice of the commencement of the chapter 11 case. Beyond that, it is up to the individual creditor to take steps to gather additional information about the case and the treatment of their claims. One way to stay in the loop is to file and serve a request pursuant to Bankruptcy Rule 2002 to be added to the service list and receive copies of all filings in the bankruptcy case. Although this may open a floodgate of mail, it is traditionally the best way to monitor a case. To cut down on document costs, some courts permit service by email and electronic document retrieval. Depending upon the nature of the claim and your level of technical savvy, this may be a better option as opposed to receiving reams of documents, many of which are irrelevant to protecting a particular creditor’s interest.

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

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

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

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

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

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

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

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

D. Understand Reclamation Rights

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

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

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

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

Protecting/Collecting Your Claim

A. Proof of Claims and Bar Dates

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

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

Given the uncertainty of the postal service, it is not a good idea to just sit back and wait for a bar date notice to arrive. Once you are aware of the bankruptcy case, you should monitor the case docket to identify the bar date for your claim(s). Although the debtor is required to serve all known creditors with actual notice, if the debtor can show that the notice was mailed to any of your business addresses, for example, you’ll be faced with a steep burden to prove that such notice was never actually received. It’s best to avoid this argument altogether and simply seek out the bar date on your own without waiting for the notice to arrive.

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

B. Monitoring the Debtor’s Chapter 11 Plan and Proposed Distribution Timeline

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

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

**Preventive Maintenance**

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

**A. Avoiding Preference Liability**

Many creditors don’t realize it, but in addition to being left on the hook for their unpaid pre-petition claims, they may also be liable to the debtor’s estate for receiving pre-petition preferential payments (a/k/a preferences). As discussed in Chapter 7, the Bankruptcy Code permits a debtor to sue creditors to recover payments made by the debtor shortly before the bankruptcy filing where the payment gave the creditor more than other, similarly situated creditors would get through the bankruptcy process.

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

**B. Monitor Debtor’s Solvency**

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

As mentioned briefly above, if you become aware that a particular company is a credit risk and may potentially seek bankruptcy protection, you can significantly reduce your exposure by initiating certain payment alternatives that will protect your interests in the event of a filing. These alternatives include obtaining advance payment or cash on delivery (COD) for shipments, establishing an evergreen retainer or cash deposit, obtaining letters of credit, and entering into third-party guarantees.
# Appendix 9(a) Form B10

## United States Bankruptcy Court

**Name of Debtor**

**Case Number**

**DISTRICT OF**

**PROOF OF CLAIM**

### Note:

This form should not be used to make a claim for an administrative expense arising after the commencement of the case. A "request" for payment of an administrative expense may be filed pursuant to 11 U.S.C. § 503.

### Name of Creditor (The person or other entity to whom the debtor owes money or property):

- [ ] Check box if you are aware that anyone else has filed a proof of claim relating to your claim. Attach copy of statement giving particulars.
- [ ] Check box if you have never received any notices from the bankruptcy court in this case.
- [ ] Check box if the address differs from the address on the envelope sent to you by the court.

**Name and address where notices should be sent:**

**Telephone number:**

**Last four digits of account or other number by which creditor identifies debtor:**

- [ ] Check here if this claim replaces a previously filed claim, dated:

### Basis for Claim

- [ ] Goods sold
- [ ] Services performed
- [ ] Money loaned
- [ ] Personal injury/wrongful death
- [ ] Taxes
- [ ] Other

- [ ] Retire benefits as defined in 11 U.S.C. § 1144(a)
- [ ] Wages, salaries, and compensation (fill out below)

### Last four digits of your SS #:

Unpaid compensation for services performed from _______ to _______

(date) to (date)

### Date Debt was Incurred:

### If court judgment, date obtained:

### Classification of Claim:

See reverse side for important explanations.

#### Unsecured Nonpriority Claim

- [ ] Check this box if: (a) there is no collateral or lien securing your claim, or
- [ ] your claim exceeds the value of the property securing it, or if (c) none or only part of your claim is entitled to priority.

**Amount entitled to priority**

Specify the priority of the claim:

- [ ] Domestic support obligations under 11 U.S.C. § 507(a)(1)(A) or (A)(B)
- [ ] Wages, salaries, or commissions (up to $10,000),* earned within 180 days before filing of the bankruptcy petition or cessation of the debtor's business, whichever is earlier - 11 U.S.C. § 507(a)(4)
- [ ] Contributions to an employee benefit plan - 11 U.S.C. § 507(a)(5)

### Total Amount of Claim At Time Case Filed:

- [ ] Check this box if claim includes interest or other charges in addition to the principal amount of the claim. Attach itemized statement of all interest or additional charges.

**Total**

- [ ] Check this box if claim includes interest or other charges in addition to the principal amount of the claim. Attach itemized statement of all interest or additional charges.

**($unsecured)**

**($secured)**

**($priority)**

**($Total)**

### Creditors:

The amount of all payments on this claim has been credited and deducted for the purpose of making this proof of claim.

### Supporting Documents:

Attach copies of supporting documents, such as promissory notes, purchase orders, invoices, itemized statements of running accounts, contracts, court judgments, mortgages, security agreements, and evidence of perfection of lien. DO NOT SEND ORIGINAL DOCUMENTS. If the documents are voluminous, attach a summary.

### Date-Stamped Copy:

To receive an acknowledgment of the filing of your claim, enclose a stamped, self-addressed envelope and copy of this proof of claim.

**Date**

Sign and print the name and title, if any, of the creditor or other person authorized to file this claim (attach copy of power of attorney, if any):

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*Amounts are subject to adjustment on 4/1/07 and every 3 years thereafter with respect to cases commenced on or after the date of adjustment.

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Penalty for presenting fraudulent claims: Fine of up to $500,000 or imprisonment for up to 5 years, or both. 18 U.S.C. §§ 152 and 3571.
**INSTRUCTIONS FOR PROOF OF CLAIM FORM**

The instructions and definitions below are general explanations of the law. In particular types of cases or circumstances, such as bankruptcy cases that are not filed voluntarily by a debtor, there may be exceptions to these general rules.

### DEFINITIONS

**Secured Claim**
A claim is a secured claim to the extent that the creditor has a lien on property of the debtor (collateral) that gives the creditor the right to be paid from that property before creditors who do not have liens on the property.

Examples of liens are a mortgage on real estate and a security interest in a car, truck, boat, television set, or other item of property. A lien may have been obtained through a court proceeding before the bankruptcy case began; in some states a court judgment is a lien. In addition, to the extent a creditor also owes money to the debtor (has a right of setoff), the creditor’s claim may be a secured claim. (See also Unsecured Claim.)

**Unsecured Claim**
If a claim is not a secured claim it is an unsecured claim. A claim may be partly secured and partly unsecured if the property on which a creditor has a lien is not worth enough to pay the creditor in full.

**Unsecured Priority Claim**
Certain types of unsecured claims are given priority, so they are to be paid in bankruptcy cases before most other unsecured claims (if there is sufficient money or property available to pay these claims). The most common types of priority claims are listed on the proof of claim form. Unsecured claims that are not specifically given priority status by the bankruptcy laws are classified as Unsecured Nonpriority Claims.

### Items to be completed in Proof of Claim form (if not already filled in)

**Court, Name of Debtor, and Case Number:**
Fill in the name of the federal judicial district where the bankruptcy case was filed (for example, Central District of California), the name of the debtor in the bankruptcy case, and the bankruptcy case number. If you received a notice of the case from the court, all of this information is near the top of the notice.

**Information about Creditor:**
Complete the section giving the name, address, and telephone number of the creditor to whom the debtor owes money or property, and the debtor’s account number, if any. If anyone else has already filed a proof of claim relating to this debt, if you never received a proof of claim, or if this proof of claim replaces or changes a proof of claim that was already filed, check the appropriate box on the form.

1. **Basis for Claim:**
   - Check the type of debt for which the proof of claim is being filed. If the type of debt is not listed, check “Other” and briefly describe the type of debt. If you were an employee of the debtor, fill in your social security number and the dates of work for which you were not paid.

2. **Date Debt Incurred:**
   - Fill in the date when the debt first was owed by the debtor.

3. **Court Judgment:**
   - If you have a court judgment for this debt, state the date the court entered the judgment.

4. **Classification of Claim Secured Claim:**
   - Check the appropriate place if the claim is a secured claim. You must state the type and value of property that is collateral for the claim, attach copies of the documentation of your lien, and state the amount past due on the claim as of the date the bankruptcy case was filed. A claim may be partly secured and partly unsecured. (See DEFINITIONS, above).

   **Unsecured Priority Claim:**
   - Check the appropriate place if you have an unsecured priority claim, and state the amount entitled to priority. (See DEFINITIONS, above). A claim may be partly priority and partly nonpriority. For example, the claim is for more than the amount given priority by the law. Check the appropriate place to specify the type of priority claim.

   **Unsecured Nonpriority Claim:**
   - Check the appropriate place if you have an unsecured nonpriority claim, sometimes referred to as a “general unsecured claim” (see DEFINITIONS, above). If your claim is partly secured and partly unsecured, state the amount that is unsecured. If part of your claim is entitled to priority, state the amount not entitled to priority.

5. **Total Amount of Claim at Time Case Filed:**
   - Fill in the total amount of the entire claim. If interest or other charges in addition to the principal amount of the claim are included, check the appropriate place on the form and attach an itemization of the interest and charges.

6. **Credits:**
   - By signing this proof of claim, you are stating under oath that in calculating the amount of your claim you have given the debtor credit for all payments received from the debtor.

7. **Supporting Documents:**
   - You must attach to this proof of claim form copies of documents that show the debtor owes the debt claimed or, if the documents are too lengthy, a summary of those documents. If documents are not available, you must attach an explanation of why they are not available.
APPENDIX 9(b)
COMMITTEE NOTES

Form 10

1991 COMMITTEE NOTE

This form replaces former Official Forms No. 19, No. 20, and No. 21. The box format and simplified language are intended to facilitate completion of the form.

The form directs the claimant to attach documents to support the claim or, if voluminous, a summary of such documents. These include any security agreement (if not included in the writing on which the claim is founded), and evidence of perfection of any security interest. See Committee Note to Rule 3001(d) concerning satisfactory evidence of perfection. If the claim includesprepetition interest or other charges such as attorney fees, a statement giving a detailed breakdown of the elements of the claim is required.

Rule 2002(g) requires the clerk to update the mailing list in the case by substituting the address provided by a creditor on a proof of claim, if that address is different from the one supplied by the debtor. The form contains checkboxes to assist the clerk in performing this duty. The form also alerts the trustee when the claim is an amendment to or replacement for an earlier claim.

1993 COMMITTEE NOTE

The form has been amended to accommodate inclusion of the priority afforded in § 507(a)(8) of the Code, which was added by Pub. L. No. 101-647, (Crime Control Act of 1990), and to avoid the necessity of further amendment to the form if other priorities are added to § 507(a) in the future. In addition, sections 4 and 5 of the form have been amended to clarify that only prepetition arrearages and charges are to be included in the amount of the claim.

1995 COMMITTEE NOTE

The form is amended to add the seventh priority granted by the Bankruptcy Reform Act of 1994 to debts for alimony, maintenance, or support of a spouse, former spouse, or child of the debtor. The form also amends the Code reference to the priority afforded to tax debts and the dollar maximums for the priorities granted to wages and customer deposits in conformity with amendments made by the 1994 Act to section 507(a) of the Code. The 1994 Act also amended section 104 of the Code to provide for future adjustment of the dollar amounts specified in section 507(a) to be made by administrative action at three-year intervals to reflect changes in the consumer price index. The form is amended to include notice that these dollar amounts are subject to change without formal amendment to the official form.
1997 COMMITTEE NOTE

Numbered sections 4. and 5. of the form have been reformatted to eliminate redundant information and make it easier to complete the form correctly. A creditor will report the total amount of the claim first, and will report only that amount unless the claim is secured by collateral or entitled to a priority under § 507 of the Code.

Explanatory definitions and instructions for completing the form also have been added.

2003 COMMITTEE NOTE

The form is amended to require a wage, salary, or other compensation creditor to disclose only the last four digits of the creditor’s social security number to afford greater privacy to the creditor. A trustee can request the full information necessary for tax withholding and reporting at the time the trustee makes a distribution to creditors.

2005 COMMITTEE NOTE

CHAPTER 10
PRIORITIES

The priority scheme in bankruptcy dictates the order in which claims are paid. Think of a ladder. The claims standing on the highest rung must be paid in full before any claims on the next rung can be paid anything. The senior class of creditors gets paid in full, then the next class, and so forth, until you come to a class for which assets are insufficient to pay everyone in full.

What happens then? The basic principle is one of *pro rata* distribution among similarly situated creditors. This is supposed to supplant the “race to the courthouse” that would occur if not for automatic stay of bankruptcy. It sounds simple and fair. But—as with many things in bankruptcy—it’s less simple than it initially appears, and whether you think it’s fair probably depends on what rung of the ladder you find yourself standing.

For starters, let’s make sure we understand what we mean when we talk about *pro rata*. It’s pretty straightforward: *pro rata* means that when there are not enough assets to go around, then each creditor gets a share determined by the size of his allowed claim. So if there is enough to pay 20 percent of all claims in a given class, then we pay each creditor in that class 20 percent of his claim.

For example, suppose the Debtor owes $10 to the Butcher, $20 to the Baker and $30 to the Candlestick Maker—a total of $60. The Debtor has $12—just 20 percent of what he owes. Under nonbankruptcy law, assets would go first to the fastest, and others would be left empty-handed. Under the pro-rata rule of bankruptcy, since we have assets equal to 20 percent of all claims, we would pay 20 percent of each claim. So, Butcher would get $2, Baker would get $4, and Candlestick Maker would get $6.

Such is the basic bankruptcy rule. But at least four facts conspire to assure it almost never works out that way.

First and most important, in many cases there are no assets to distribute to creditors. This is particularly true in chapter 7. One hundred percent of nothing is nothing. Second, the Bankruptcy Code itself mandates a schedule of priority claims. *See Bankruptcy Code §§507 and 726*. We will consider these statutory priorities in more detail below. For now, suppose that Butcher has a priority claim, and that Baker and Candlestick Maker have non-priority claims (*i.e.*, Butcher is on a higher rung of the ladder). We will pay Butcher $10. That leaves $2 for distribution between Baker and Candlestick Maker, *pro rata*. Even where there are assets to distribute, in many cases the priority claims will eat up the assets before we ever get to the residual non-priority class.

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1  *See Appendix 10(a).*
But there is more. The most important “priority” isn’t even on the priority list. That is: a creditor with a valid and perfected security interest in property of the estate will have first dibs on that property. For example, in our case, suppose the asset pool valued at $12 includes a widget, valued at $9, in which Butcher has a perfected security interest. Butcher gets the whole $9 value of the widget. There is still $3 of value left in the estate, and Butcher still has a $1 shortfall unpaid on his claim. Butcher (on his $1 shortfall) shares pro rata with Baker and Candlestick Maker on their claims.

The bankruptcy priority schedule is, as we say, explicit in the statute. Oddly enough, neither of the other rules (neither “pro rata” nor “secured comes first”) is spelled out in any detail. But there’s no doubt that they are the law. Indeed, that is the point: they are so basic that nobody thought to say so. There are plenty of Code provisions that recognize these basic rules, at least in a backhanded way. If you find the rule spelled out at all, you can suss it out of a series of Supreme Court cases, starting perhaps with Long v. Bullard, 117 U.S. 617 (1886) and extending through to Dewsnup v. Timm, 502 U.S. 410 (1992).

As if this weren’t enough, there are at least two other principles that complicate the distribution scheme. First, in a chapter 11 case, the court may confirm a plan of reorganization which (within limits) can vary the off-the-rack rules of distribution. Second, the Bankruptcy Code also provides that the judge may, in an appropriate case, “subordinate” one claim to another. See §510. Likewise, case law permits the court (under limited circumstances) to “recharacterize” debt as equity—which of course has an impact on the priority scheme.

The Priority Scheme for Unsecured Creditors

The priorities among unsecured creditors are set forth in §507. Note the section number: this means that the priority rules are part of chapter 5, and recall that chapter 5 applies to all kinds of bankruptcy cases, including liquidating cases under chapter 7 and reorganization cases under chapter 11.

Domestic Support Expenses and Trustee Fees

Bankruptcy Code §507(a)(1) gives first priority to domestic support expenses. Interestingly, the priority for domestic support is likely to be of little value to spouses in the low income chapter 7 cases, which are usually no asset cases to begin with but where, presumably, the payment of support obligations is most important to the spouse. It may however, afford ex-spouses some relief in chapter 13 in 11 cases, where higher income debtors are forced to file. This first priority for domestic support obligations is new law as of 2005, enacted as part of BAPCPA. But ignore it: it’s a distraction. For one thing, it doesn’t apply in corporate cases, period (corporations don’t get divorces anyway). In individual cases, there are plenty of domestic obligation claims—but in the vast majority of cases where there are domestic obligations claims, there is no money to pay any claims at all, so the priority still doesn’t amount to anything.

Administrative Expenses

The “real” first priority is the second: §507(a)(2) gives a second priority to “administrative expenses allowed under §503(b).” Bankruptcy Code §503(b)(1)(A) in its turn
defines “administrative expenses” as “the actual necessary costs and expenses of preserving the estate.” This is, among other things, the place where the lawyers get paid: fees for non-trustee professionals who represent the estate are administrative expenses (but all subject to court control see, e.g., §§327, 330).

And note “necessary,” italicized above. This is the stuff that litigation is made of, and some courts have found wiggle room here. The 2005 reform legislation expanded this definition’s nonexclusive list of administrative expenses to include post-petition employee pay, NLRB back-pay rewards, up to two years of rent under a lease that is first assumed then rejected, the costs of closing a health care facility, and the value of 20 days of pre-petition goods delivered to the debtor. See §503(b) This priority also encompasses post-petition taxes incurred by the estate. See §503(b)(7)(B)

Taxes

Aside from administrative expenses, probably the next most important priority is the priority for taxes. See §507(a)(8). There are three quick points about the tax priority that must be made. First, this tax priority stands only eighth on the statutory priority ladder. As a practical matter, however, the tax priority is a lot more important than several of those that precede it. Second, the priority applies only to unsecured tax claims. In plenty of cases, the tax collector will have statutory tax lien—a kind of secured claim. Working out the relationship between the secured lien claim and the unsecured priority claim is a bankruptcy subspecialty all its own, but the beginning of wisdom is to know that they are different. Third, the priority applies only to tax claims—not to government claims in general. The government’s non-tax claims have no special priority under the Code, although what is and is not a tax claim is, again, something that can be fought over.

Employee Priorities

Two subsections of §507 address the claims of employees where the debtor is the employer. Subsection 507(a)(4) gives a limited priority for wage claims; subsection 507(a)(5), for claims under employee benefit plans. These claims are often matters of great urgency to individual employees. Indeed, a practice has developed of paying these priority claims (now up to $10,000 per employee) soon after the case has been filed. This requires court approval—and there’s nothing in the Bankruptcy Code that specifically authorizes the court to grant such approval—but courts commonly grant the relief anyway.

In an operating chapter 11, the employee priority claims aren’t likely to be a deal-driver. If there is an employee issue in a complex business chapter 11 case, it is more likely to involve the issue of employer liability under a government-guaranteed pension plan, the matter of employee rights under a collective bargaining agreement, or proposed retention incentive plans.

Other Priorities—Above and Below the List

Most of the other provisions of Bankruptcy Code §507 are special-interest rules that have little or nothing to do with the ordinary case. But there are two other kinds of statutory priorities.
One is the matter of priorities “above the list”—so-called “superpriorities.” The other is the matter of priorities “below the list”—residual priorities for liquidating cases under §726.

First, superpriorities. We saw above that the first priority goes to administrative expenses. But not all administrative expenses are created equal. For example, a party who extends post-petition financing to a debtor under §364 often negotiates for a “superpriority” that trumps other administrative claims. Also, a claim for failure of adequate protection has a super priority. See §507(b). And on occasion you will see a court order that purports to create other “superpriorities” even though not provided for in the Bankruptcy Code. This can happen, for example, with breakup fees payable to outbid prospective purchasers in §363 sales.

And perhaps the highest priority of all is the priority that trumps the claim of the perfected security interest. Bankruptcy Code §506(c) permits the trustee to recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim including the payment of all ad valorem property taxes with respect to the property. Only the DIP may assert a surcharge claim; creditors may not assert it. There are other “priorities” that have the effect of trumping secured claims. One is the “priming lien” for post-petition financing under Bankruptcy Code §364(d). Another is the “carve-out” often agreed to by secured lenders for the benefit of debtor and committee professionals.

Second, priorities “below the list.” Bankruptcy is about debtors who don’t have enough money to go around. But once in a while, you run into a solvent estate—a case where there is enough to pay all priority and general unsecured claims (maybe market prices shot up after filing). In those cases, you might think the residual would go back to the debtor or its shareholders. In chapter 11, that is the general rule. But in a chapter 7 liquidating case, even after all §507 priorities are paid, money does not go to the debtor until you have paid the separate list of “liquidating priorities” in §726, including such things as late-filed claims, punitive damages, and post-petition interest.

Priority for Essential Trade Vendors

We have mentioned a few ways that a court order can create a priority that’s not provided for in the Bankruptcy Code. One example worthy of special note is the “essential trade vendor.” Usually these are creditors who have only general unsecured claims, but they jump to the front of the line, getting paid in full even though other claims of a similar rank will probably wait a long time for any payment, and then receive only cents on the dollar. The argument is that these “essential trade vendors” are necessary for the debtor’s survival, and they won’t continue to ship to the debtor unless they are paid in full. Courts often agree with this argument, although it appears that the “essential trade vendor” argument has been somewhat aggressively overused, and that courts are becoming more skeptical. One example of this is the decision of the Seventh Circuit in the Kmart case.

Maybe You Own the Asset?

One way to obtain “priority” over other creditors is to establish that you own the asset in question rather than it being property of the estate, so that other creditors should have no interest
in it at all. “Great,” you say, “but how can I manage that?” The answer is, it’s not easy. After all, taking assets out of the estate is inconsistent with the notion of pro rata distribution. But there are cases where it can be achieved. And its worthwhile to think about this for a few minutes before you assume that you are a creditor who must stand in line with everyone else.

One example is the “constructive trust”—a remedy that may be available to a creditor that was the victim of theft or similar wrongdoing. If you prevail, you may have “your asset” returned to you, rather than divided among creditors.

Another example is the “absolute assignment of rents” that has been recognized by some courts, allowing a mortgage lender “ownership” of the rents rather than a mere security interest.

And a few courts have recognized “equitable liens”— this one won’t give you ownership of the asset, but it may have the same effect—an unsecured creditor may find itself fully secured.

Some Other Priorities Spread Throughout the Code

There are a few other sections of the Bankruptcy Code that set forth de facto priorities. They may not be thought of as priorities, but they have the same effect. For example, §553 permits a creditor who has a right of setoff to get paid in full (after obtaining stay relief) to the extent of his setoff right, affording priority over other creditors and essentially providing secured creditors status to the set off creditor. And a reclamation creditor may get an administrative claim or a lien that gives it priority over other unsecured creditors, under §546(c). Then there are more obscure priorities, such as the rights of customers in a brokerage firm’s bankruptcy. Once again, the lesson is to think creatively before you resign yourself to sharing pro rata.

Some Notes on Secured Credit

First, the secured creditor has a right to first dibs on his collateral to the extent of his claim. In other words, if she has a claim for $100 and the collateral is worth $500, she has first dibs to the tune of $100, not $500. Actually, as an oversecured creditor, she will have a right to $100 plus post-petition interest and maybe her fees and expenses too. See §506(b). Second, she has a right to the value of her claim, not necessarily the right to receive the collateral itself. The debtor may elect to give a secured creditor its collateral, in satisfaction of its claim, but the creditor cannot insist on that treatment. Third, if the security interest is not disposed of in the bankruptcy case, then it “rides through” and remains the creditor’s collateral. So if the secured creditor does not file a proof of claim, and the debtor does not deal with the claim or lien in its plan, the lien will continue in effect (although if we were counsel for the secured lender, we would be loathe to sit back and rely on the ride through).
APPENDIX 10(a)
PRIORITY LADDER

Expense to preserve or sell collateral. 506(c)
“Priming” lien for new money. 364(d)
Pre-bankruptcy secured claim and “equal” lien for new money. 506(a) & 364(d)
Court-ordered priority for new unsecured debt. 364(c)(1)
Claim of secured creditor if he is not adequately protected. 507(b)
Domestic Support payments. 507(a)(1)
Administrative expenses, consisting of the following, all of equal rank:
Reclaiming seller; 546(c)
Costs of preserving the estate, taxes incurred by the estate and compensation to trustees, attorneys, professional persons, etc., costs of closing a health care business, value of goods sold to debtor within 20 days before commencement of case, payments on an assumed lease for nonresidential property; 503(b)
Unsecured debt incurred in ordinary course of business by the estate; and 364(a)
Unsecured debt out of ordinary course if authorized by Court 364(b)
Gap claims, wages, fringes, employee benefit plans, grain storage and fisherman, security deposits, taxes, and claims for death or injury from operating a vehicle under the influence, in that order. 507(a)(3)-(10)
Timely filed general allowed unsecured claims. 726(a)(2)
Tardily filed general allowed unsecured claim without notice of case and filed in time for distribution. 726(a)(3)
Pre-petition punitive damages, fines, and penalties. 726(a)(4)
Interest from date of filing 726(a)(5)
To the debtor. 726(a)(6)

Appendix 10(a) - Priority Ladder 163 Chapter 11-101
CHAPTER 11
OBTAINING DIP FINANCING AND USING CASH COLLATERAL

For the outsider, one of the oddest things about chapter 11 is that one can make money by lending money to a debtor in bankruptcy. But it’s a fact. The Bankruptcy Code’s framework for so-called “DIP financing,” a/k/a “post-petition lending” is one of the most important (and revolutionary) innovations introduced in the 1978 Code. Indeed, an entire industry has grown up around the rules authorizing post-petition finance, and a good many Chapter 11 cases would be impossible without it. And—noteeworthy for our purposes here—a good many professionals in our field spend a good portion of their professional lives conceiving, negotiating, and documenting (or challenging) these post-petition financing arrangements.

The centerpiece of the post-petition lending apparatus is Bankruptcy Code §364, which sets forth a scheme of escalating priorities for post-petition financing. We begin by outlining §364. Then we turn our attention to the rules governing “use of cash collateral.” We include discussion of cash collateral usage because even a company whose operations produce cash sufficient to enable it to self fund cannot use its cash without complying with these rules, if the cash generated constitutes the cash collateral of another entity. Moreover, as you will see below, there is a high level of interrelatedness between the two topics.

Basic Substantive Framework Governing DIP Financing

Bankruptcy Code §364 authorizes the DIP to “obtain credit.” More to the point, it outlines four paths whereby a lender may achieve priority for money advanced to a debtor after the petition date. They are:

- If the DIP borrows “in the ordinary course of business,” then the lender’s claim is a first-priority administrative expense under §364(a). This priority is perhaps best understood as a protection for post-petition trade vendors.

- Even outside the ordinary course of business, the creditor may get an administrative priority if the post-petition advance, and the administrative priority, is approved by a court order. This is §364(b). But as a practical matter it doesn’t happen very often, because most creditors who provide post-petition lending insist on the greater protections afforded by subsections (c) and (d).

- If the DIP can’t get unsecured credit, the court may authorize the lender to get a “super-priority” administrative claim or the court may authorize the lender to take a security interest in unencumbered property (or a subordinate security interest in encumbered property). This is §364(c). The Bankruptcy Code seems to suggest that a lender may obtain either a super-priority administrative expense or a post-petition lien, but not both. However, we have seen many situations in which both of these protections were granted to a DIP lender.
Finally, if the DIP cannot get credit otherwise, the court may authorize a security interest that is “senior or equal” to an existing security interest. This is §364(d). A DIP loan with a lien that is senior in priority to existing pre-petition liens is sometimes referred to as a “priming lien.” It is the most extraordinary protection for a post-petition lender. It requires showing that the lender whose lien is “primed” is adequately protected. Priming liens are not often approved over the objection of the pre-petition secured lender, but it does happen sometimes. And, the pre-petition lender will sometimes agree to the priming lien in order to induce a new lender to advance money post-petition.

In order to obtain approval of one of these escalating priorities, the DIP must show the court that financing was not available with one of the lower priorities. §364(c)–(d). At the hearing, the DIP should be prepared to discuss its efforts to obtain financing on less onerous terms.

**Basic Substantive Framework Governing the Use of Cash Collateral**

You learned in earlier chapters that, in chapter 11, the DIP can continue to operate his business without court order until the judge orders otherwise. But lawfulness is only one issue: practicalities are another. The ordinary debtor won’t make it to lunchtime without some operating income. And, as explained above, this is why a debtor that is strapped for cash must be able to borrow money. But, what if the debtor’s operations produce sufficient cash so that it does not need to borrow money? Well, even if it does have the cash, the chances are that all of it was pledged, pre-petition, to secured creditor(s).

Security agreements typically give the secured creditor a first-priority security interest in all of the debtor’s (a) inventory; (b) accounts receivable; and (c) proceeds of inventory or accounts receivable. In the ordinary course, this works fine: inventory becomes accounts, which becomes cash, which becomes new inventory and so forth. But now in chapter 11, it means the creditor has its hands on the debtor’s throat: the debtor can’t do anything without cash, and he can’t touch the encumbered cash or cash equivalents (“cash collateral”) without permission of the secured creditor or a court order.

Bankruptcy Code §363(c)(2) provides that the DIP may use “cash collateral” only with (a) creditor consent; or (b) a court order. In a contested hearing, the pre-petition lender has the burden to prove the “validity, priority, or extent” of its interest in cash collateral. The debtor has the burden of proving that the pre-petition lender is “adequately protected.” Bankruptcy Code §363(o) lays out these rules. Adequate protection is defined in §361.

Negotiated cash collateral orders are fairly common. This is predictable for several reasons. First, use of cash is essential to preserve going concern value. Thus, there is typically a strong unity of interest on this matter between a debtor and its pre-petition lender, even where there are other disagreements. Second, courts tend to understand the need, and so are inclined to allow cash collateral use. Finally, a lender can enhance its position by negotiating certain terms into an “agreed” cash collateral order.
This last point requires amplification: A pre-petition lender is also often the DIP lender in a chapter 11 case. Thus, a single motion often combines a request to use cash collateral with a request to incur DIP financing. A common tactic of such pre-petition lenders/DIP financiers is to characterize a contemplated DIP financing that includes permission to use cash collateral as purely a DIP financing. Bankruptcy courts, however, understand that different rights ought to inure to a lender who makes a truly new advance of funds as opposed to a lender who is merely permitting the use of cash collateral. More on this below.

**Procedural Overview (of DIP Financing and Cash Collateral Motions)**

Requests for approval of cash collateral usage and DIP loans often come to the court on a very expedited basis, within the first few days of the case. In the extreme (but not unusual) case, the DIP and the secured creditor show up in court on an emergency motion, filed moments after the case was filed, seeking an instant authorization for a post-petition line of credit. The request arrives accompanied by a proposed order about the size of the Topeka phonebook, outlining the terms and conditions to which the DIP and the creditor agreed. And (the secured creditor and DIP repeat in unison), the judge needs to sign the order *now*, so the business can continue to operate.

Judges (not to mention USTs) are often concerned that (1) they don’t have sufficient time to review and develop an understanding of what they are being asked to approve, (2) creditors don’t have an opportunity to review the arrangement, even though it can have a substantial impact on the rest of the case, and (3) no creditors’ committee is in place. Courts struggle to balance the legitimate interests of the parties with these concerns.

Bankruptcy Rule 4001 addresses these concerns. It provides, first, for an interim hearing at the beginning of the case, followed by a full-blown hearing at least 15 days later. At the interim hearing, the court may authorize DIP financing and/or cash collateral use only to the extent necessary to avoid irreparable damage pending the final hearing. Some courts impose additional requirements that have the effect of causing a further delay before a final hearing can take place. For example, some courts will not conduct a final hearing on DIP financing before a committee is appointed and has had the opportunity to engage counsel.

Even within the framework of Rule 4001, courts have expressed a good deal of anxiety over the content of DIP financing and cash collateral orders. One example of this concern is an open letter Bankruptcy Judge Peter J. Walsh wrote to the Delaware Bar. In his letter Judge Walsh itemized a number of provisions which, he said, parties should ordinarily avoid seeking in interim DIP and cash collateral motions. These include:

- provisions that are “just too verbose and cover unnecessary matters;”
- provisions that incorporate specific sections of underlying loan documents without a statement of the sections’ import;
- provisions that state the court has examined all of the underlying loan documents or that it approves of their terms;
• lengthy recitations of fact concerning the relationship between the debtor and the lender (and suggesting instead the use of stipulations);

• statements that parties in interest have been afforded “sufficient and adequate notice” (and suggesting that the order recite instead that the hearing is being held pursuant to Bankruptcy Rule 4001(c)(2) and listing the parties to whom notice was given);

• provisions that grant the lender a lien on avoidance actions;

• any attempt to limit the committee’s right to challenge a lender’s pre-petition position to less than 60 days (and in most cases to less than 90 days) or to not grant committee counsel a carve-out; and

• provisions that expressly or by their terms have the effect of divesting a debtor of any discretion in formulating a plan.

A copy of Judge Walsh’s letter is included in Appendix 11(a). Other courts have local rules or other written guidance along the same lines. One common requirement is that specific provisions (such as cross collateralization, §506(c) waivers, lien on avoidance actions, and the like) be identified in a motion, so the judge does not inadvertently miss seeing them.

**Bedrock Planning Steps**

The first steps in thinking about cash collateral and/or DIP financing issues should involve thorough due diligence of existing loan documents. Not surprisingly, a pre-petition lender’s attitude in negotiations can change dramatically when it learns that it did not properly perfect or has some other problem of which it was previously unaware.

The development of a budget of cash expenditures is also essential. First, as described above, the court has to be able to review it to make sure that it approves only that which is essential at the initial hearing stage. Just as importantly, lenders demand it because they want to make sure that cash is being spent in a way they think makes sense (i.e., in a way that will maximize the likelihood of their getting repaid). Liquidation valuations are also likely to be demanded by pre and post petition lenders alike. Pre-petition lenders need them to weigh the desirability of a liquidation against a reorganization; post-petition lenders need them to assess the collateral base of their loans.
April 2, 1998

Re: First Day DIP Financing Orders

Dear Delaware Bankruptcy Counsel:

This is a follow-up to our session of March 11, 1998, where, at the prompting of Judge McKelvie, we discussed the need for improving the DIP financing orders being submitted at first day hearings. At that meeting, I gave a number of examples of provisions in several orders that I thought were either unnecessary, overreaching, or just plain wrong. In an effort to improve the content of first day DIP financing orders, I volunteered to comment in writing on the forms and to identify a number of terms or provisions in those orders that I believe should be avoided.

The following items, in no particular order of priority (except as to the first item), are not intended as immutable rules that I have on the matter, and certainly I have no authority to speak for the other judges on these matters, but I thought if we could shorten and eliminate some of the more objectionable features of proposed first day DIP financing orders, we could improve the first day proceeding. Needless to say, however, I think it is not practicable to have a blanket set of prohibitions, given the numerous variations in the lending arrangements and the pre-petition relationships between the debtor and the lender(s).

1. Many of the proposed orders are just too verbose and cover unnecessary matters. It is not necessary for the order to recite, even in summary fashion, the major provisions of the loan occurrences. For example, the following is a portion of a paragraph included in a recent DIP financing order, which obviously paraphrases what the loan document says on this particular matter:

   All advances and other extensions of credit and financial accommodations shall be made solely on the terms and conditions of, and pursuant to, the post-petition Loan Agreement and the other post-petition Loan Documents, shall be evidenced by the Lenders’ books and records, and shall be due and payable as provided in those agreements. The Lenders shall have no commitments to make any advances or other
If the DIP financing order authorizes the debtor to enter into the financing pursuant to the loan documents, it is simply not necessary for the order to restate a lot of the major terms of the financing. (Indeed, most of the above-quoted statement states the obvious for the type of loan transaction that we see on the first day.) The motion itself should spell out the terms that are essential to an understanding of the deal: maximum borrowing, interim borrowing limit, borrowing conditions (e.g., percentage of inventory value), interest rate, maturity, events of default, use of funds limitations, collateral, and/or priority, etc., but I do not see that it is necessary to get into a lot of details on these in the order. Of course, the order should identify those sections of the Bankruptcy Code designed to protect the estate and/or creditors generally that are being limited or abridged in any matter by the terms of the documents.

2. Do not incorporate into the order specific sections of the loan documents without a statement of the section’s import. In a recent case the proposed order contained a decratal paragraph regarding events of default that specifically referenced about a dozen particular sections of the loan agreement and tied them into the issue covered by the decratal paragraph. It is simply unrealistic to expect that I can fully read and digest all the provisions of the loan documents in the few hours those documents are in my possession leading up to the first day hearing. Reciting specific ties between the terms of the order and particular terms or provisions of the loan agreement is something that under most circumstances on the first day I cannot comfortably append my signature to.

3. Given the limited amount of time we have to review the first day motions prior to the hearing and given the substantial amount of paperwork presented, particularly the DIP financing motion with the loan documents and the related order, it is not realistic to have a provision in the order that recites that the Court has “examined” all the loan documents, or that the Court “approves” all the terms and provisions of the loan documents, or language of similar import. An egregious example in this regard reads: “The provisions of the Postpetition Loan Agreement and other Postpetition Loan Documents are hereby approved and by this reference incorporated herein as a part of this Order.” Remember, the Court is authorizing the debtor to borrow money on basic terms that appear reasonable under the expedited circumstances; it is not placing its imprimatur on the multiple terms and conditions of the loan documents.

4. Many of the proposed orders contain lengthy recitations of findings that are preambles to the decratal portion of the order. Given the fact that at most first day hearings only the debtor is heard, it is somewhat presumptuous, and in many cases unduly aggressive, for counsel to hand up an order that sets forth detailed, and in many cases nonessential, findings by the Court regarding prepetition deals, relationships, and understandings of the parties. Most of
these findings are based on lengthy recitations in the motion papers. It seems to me, given the limited nature of the first day hearing, that most or these “findings” would better be recited under a heading of “stipulations” between the debtor and the lender. Please note, if the stipulation approach is used, do not put further back in the order a decretal statement that says something to the effect that all the terms and provisions of the subject order constitute an order of the Court. By its nature the order will be acknowledging the stipulations, and of course, appropriate court findings will be a part of the order.

5. The order should not state that parties in interest have been given “sufficient and adequate notice” of the motion. Nine times out of ten this is simply not true. Rule 4001(c)(2) contemplates an expedited hearing with little or no notice (at least not the type of notice that would be sufficient to prepare for an effective participation by third parties). Consequently, the order should simply recite that the hearing is being held pursuant to the authorization of Rule 4001(c)(2) and recite to whom and when the notice was given.

6. Given the limited nature of the hearing on the first day, the findings that are necessary for the §364(e) protection afforded the lender can appropriately be expressed in language such as: “Based on the record presented to the Court by the Debtor, it appears that…”

7. Absent exigent circumstances, neither the loan documents nor the order should give the lender a lien position on avoidance actions.

8. While, in order to give the prepetition/postpetition creditor protection typically demanded, it is appropriate for the debtor to acknowledge the validity, perfection, enforceability, and nonavoidability of the prepetition indebtedness and perhaps waive any lender liability claims, this provision should preferably be in the form of a stipulation and should be limited to the debtor so that it is not binding on the estate, the committee, or a trustee. As discussed below, a time limit with respect to nondebtor challenges to the prepetition secured position may be appropriate.

9. Where a DIP financing facility includes the use of the prepetition creditors’ cash collateral, adequate protection in the form of a substitute lien on postpetition collateral is appropriate to the extent there is a diminution in the value of the prepetition collateral, but such a provision should not include language such as the following: “[T]he Debtors’ use of cash collateral pursuant to this Order or otherwise is hereby deemed to result in a dollar-for-dollar decrease in the value of the Prepetition Collateral….”

10. The debtor’s obligation to reimburse the lender for costs and expenses, including attorneys’ fees, etc., should be expressed in terms of “reasonable” costs and expenses and such reimbursement obligation should not apply to the lender’s defense to challenges by a committee to the lender’s prepetition security position.

11. Carveouts for professional fees should not be limited to the debtor’s professionals, but should include the professionals employed by any official committee. While the carveout for professionals of any official committee may appropriately exclude work related to the prosecution of an objection to the pre-petition secured position of the lender, that exclusion should not encompass any prechallenge investigative work by the professionals.
12. The carveout for committee professionals and the limited period to challenge the lender’s prepetition secured position is important. In my view it is the price of admission to the bankruptcy court to obtain the benefits of preserving the assets of the estate, which preservation typically first benefits secured parties.

13. The period of time during which the creditors’ committee should have the right to challenge the lenders’ prepetition position should generally be at least sixty days from the appointment of the committee. Unless the case is on a fast track, this period should be ninety days.

14. The following provision is patently objectionable:

   Nothing contained in this Order shall be deemed a finding with respect to adequate protection (as that term is described in §361 of the Code) of the interest of the Lenders in the Prepetition Collateral, but shall [sic] the Lenders’ and security interests in the Prepetition Collateral require adequate protection, Lenders shall be deemed to have requested and shall be deemed to have been granted such adequate protection as of the Petition Date or such later date when such liens or security interests first were not adequately protected. [Emphasis added.]

15. The following provision is also patently objectionable:

   Notwithstanding anything to the contrary contained in this Order or in any of the Postpetition Agreements, the commitment of the Lenders to make loans, extend credit, and grant other financial accommodations to the Debtors shall terminate immediately and automatically, without notice of any kind, upon the institution by any person or entity of any action seeking to challenge the validity or priority of (or to subordinate) any of the Lenders’ liens or security interests on any of the Prepetition Collateral. [Emphasis added.]

16. I know of no basis for including in a financing order a finding (recently proposed) such as the following: “The Debtor’s other secured creditor(s) is/are adequately protected from any adverse consequences which might result from the consummation of the proposed post-petition secured financing between the Debtor and Lender.”

17. In reciting the protection afforded the lender by §364(e), verbose and redundant provisions such as the following are to be avoided. Furthermore, in the following quoted material the underscored language suggests to me that pre-petition debt was intended to be afforded the §354(e) protection. No such effect would be proper.

   If any or all of the provisions of this Order or the DIP Financing Agreement are hereafter modified, vacated or stayed by subsequent order of this Court or by any other court, such stay, modification, or vacation shall not affect the validity of any debt to Lender that is or was incurred pursuant to this Order or that is or was incurred prior to the effective date.
of such stay, modification, or vacation, or the validity and enforceability
of any lien, security interest or priority authorized or created by this Order
or the DIP Financing Agreement and notwithstanding such stay,
modification, or vacation, any obligations of the Debtor pursuant to this
Order or the DIP Financing Agreement arising prior to the effective date
of such stay, modification or vacation shall be governed in all respects by
the original provisions of this Order and the DIP Financing Agreement,
and the validity of any such credit extended or lien granted pursuant to this
Order and the DIP Financing Agreement is subject to the protections

18. Provisions that operate expressly or as a practical matter to divest the debtor, or
any other party in interest, of any discretion in the formulation of a plan are not viewed with
favor. I believe the lender can appropriately protect itself without attempting to dictate what may
happen with respect to a plan. For example, the lender can certainly include a loan provision
calling for repayment in full on the plan’s effective date.

19. I often find that the record established at the hearing, either by affidavit or live
testimony, is rather thin relative to the detailed findings that the Court is called upon to make. It
is important that the affidavit or the live witness (either by testimony or, if appropriate, by
proffer) offered in support of the motion be specific and complete regarding the findings required
with respect to §§364(c) and (e) and Rule 4001(c)(2).

20. The lifting of the §362 automatic stay upon the event of a default should be
conditioned upon providing three to five days’ notice to the debtor, the U.S. Trustee and any
official committee.

21. The order should be worded in a manner that makes it clear that, whatever the
terms of the interim order, the Court is not precluded from entering a final order containing
provisions inconsistent with or contrary to any of the terms of the interim order, subject, of
course, to the lender’s §364(e) protection with respect to monies advanced during the interim
period. Just by way of example, should the Court deem it appropriate, given a strong showing at
the first day hearing, to allow a waiver of §506(c), if the subsequently appointed committee
presents a persuasive argument, the Court should revisit the matter and be guided by what it
hears at the final hearing.

The items discussed above are not intended to be a complete list of the matters that need
to be addressed on the issue of first day DIP financing orders. For the most part, they are derived
from the latest four or five first day DIP financing orders that I have had before me. If I were to
go back over the last few years and review other such orders, I am sure that I could pick out
additional provisions that could be considered objectionable.
In any event, I hope that this communication will serve to give counsel sufficient incentive to make the proposed DIP financing orders more palatable while at the same time preserving those elements of the orders that the lending institutions reasonably believe are essential. Perhaps further dialogue on the matter would be appropriate at a gathering similar to that of the March 11 session.

Very truly yours,

Peter J. Walsh

PJW:vw

cc: Chief Judge Joseph J. Farnan, Jr.
Judge Sue L. Robinson
Judge Roderick R. McKelvie
Patricia A. Staiano, United States Trustee
APPENDIX 11(b)
IN RE THE COLAD GROUP, INC.

This following edited order illustrates operation of the DIP financing and use of cash collateral rules in the context of first day motions. It also illustrates the role of the judiciary in providing searching review even when all present appear to be in agreement.


This case provides an unusual opportunity to consider standards for the approval of first day motions in a case filed under chapter 11.

The Colad Group, Inc. (“Colad”) is a specialty printer, whose primary business involves the production and sale of custom folders, binders and other stationary products. On the evening of Thursday, Feb. 3, 2005, Colad electronically filed a petition for relief under chapter 11 of the Bankruptcy Code. The following day, debtor’s counsel contacted the court to schedule an opportunity on an emergency basis to seek the court’s approval of “first day orders.” For this purpose, the court reserved time for both a conference and, if necessary, a hearing, on the afternoon of Tuesday, Feb. 7. In attendance at those proceedings were counsel for the debtor; counsel from the Office of the United States Trustee; counsel for Continental Plants Group, LLC (“Continental”), the primary secured creditor in this case; and Daniel Williams, pro se.

Daniel Williams is the largest creditor in the chapter 7 bankruptcy case of William P. Brosnahan, Jr., an individual who at one time was affiliated with Colad. In the present context, it is not necessary to relate the complex and contentious issues that the Brosnahan case has presented. Rather, it suffices to note that Colad identifies the bankruptcy estate of Brosnahan as its largest unsecured creditor, and that Brosnahan’s trustee has named Colad as a defendant in various adversary proceedings. For these reasons, this court directed that the Brosnahan trustee and its largest creditor receive notice of the conference and hearing relative to any first day motions in the Colad case. Mr. Williams participated in those proceedings, and his objections have served to focus the court’s attention on a number of issues that have long had need for explication.

In bankruptcy practice, the phrase “first day motions” refers generally to any of a variety of requests made shortly after the filing of a chapter 11 petition, for prompt authorizations needed to facilitate the operation of the debtor’s business. On Feb. 7, the debtor presented eight such motions, as follows:

1. a motion to authorize payment of pre-petition employee compensation and benefits;
2. a motion to authorize payment of pre-petition sales and use taxes;
3. a motion to specify adequate assurance of payment for post-petition utility services and to prohibit utilities from discontinuing, altering or refusing service;
4. a motion to authorize the debtor to implement a key employee retention and incentive program for non-insiders;

5. a motion to approve the employment of a restructuring consultant, whose services would include those of a chief restructuring officer;

6. a motion to approve the retention of bankruptcy counsel;

7. a motion to authorize the debtor to maintain an existing cash management system and bank accounts, and to authorize the clearing of checks in transit; and

8. an application for emergency and final authority to obtain post-petition financing to be secured by a priming lien with administrative super-priority.

As of the present moment, this court has already rendered an oral decision with respect to all aspects of the above motions, with the exception of the application for final authority to obtain post-petition financing. Written orders have memorialized these oral decisions. With respect to post-petition financing, the debtor presently operates with benefit of an interim financing order. Primarily, the instant decision must address issues that relate to the terms of the final financing arrangement. However, to place the outstanding issues into context and to clarify the appropriate standard for first day orders, the court wishes to identify relevant principles and briefly recite the rationale for its ruling as to each of the motions.

In attempting to justify the grant of many first day orders, debtors will urge reliance upon the so-called “Doctrine of Necessity.” Based historically upon provisions of the Railway Labor Act, 45 U.S.C. §151 et seq., the Doctrine of Necessity finds support from §105(a) of the Bankruptcy Code, which authorizes the bankruptcy court to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”…Nonetheless, §105(a) does not create authority and rights that do not otherwise arise from the express provisions of the Bankruptcy Code. In the Second Circuit, the Court of Appeals stated the controlling interpretation of §105(a) in its decision in F.D.I.C. v. Colonial Realty Co., 966 F.2d 57, 59 (1992): “By its very terms, §105(a) limits the bankruptcy court’s equitable powers, which must and can only be exercised within the confines of the Bankruptcy Code[,]’ and cannot be used in a manner inconsistent with the commands of the Bankruptcy Code’” (citations deleted). Within this spirit, this court has discerned four principles that should apply to consideration of first day motions.

First, the requested relief should be limited to that which is minimally necessary to maintain the existence of the debtor, until such time as the debtor can effect appropriate notice to creditors and parties in interest. In particular, a first day order should avoid substantive rulings that irrevocably determine the rights of parties.

Second, first day orders must maintain a level of clarity and simplicity sufficient to allow reasonable confidence that an order will effect no unanticipated or untoward consequences.

Third, first day orders are not a device to change the procedural and substantive rights that the Bankruptcy Code and Rules have established. In particular, first day orders should
provide no substitute for the procedural and substantive protections of the plan confirmation process.

Fourth, no first day order should violate or disregard the substantive rights of parties, in ways not expressly authorized by the Bankruptcy Code.

Other principles may also apply with respect to certain first day motions, but the above list will help to explain the court’s rulings with respect to the eight motions that the debtor presented in the instant case.

I. Payments to Employees and to Taxing Authorities

The debtor’s first motion sought authority to pay pre-petition wages and benefits; its second motion sought to approve payment of pre-petition use and sales taxes. In papers filed with these motions, the debtor represented that nearly all of these wages, benefits and taxes would constitute priority claims; that the debtor had incurred these obligations in its ordinary course of operations; that the outstanding wages and benefits were pre-petition obligations that were not yet payable; that a disruption of wage and benefit payments could affect its ability to maintain its work force; and that the outstanding tax liabilities were ordinary obligations for use taxes and for sales taxes that the debtor had collected from its customers. In considering these two motions, the court was principally concerned for prejudice to the rights of general unsecured creditors. As against the interests of general unsecured creditors, the tax claims and nearly all of the employee claims held priority. No other priority claims appeared to be outstanding. Secured creditors might typically hold a superior interest in the cash that would be paid to the employees and taxing authorities, but here, the secured creditor consented to the debtor’s proposed distribution. Based upon that consent and upon the various representations made on behalf of the debtor, the court granted both motions in substantial part. With respect to employee wages and benefits, however, the distribution could not exceed the priority limits of 11 U.S.C. §507(a)(3) and (4), except for an amount that the court deemed to be de minimis and with restrictions on payments to an insider.

II. Post-petition Utility Services

Without prior notice to utilities, the debtor also moved for an order specifying adequate assurance of payment for post-petition utility services and to prohibit utilities from discontinuing, altering or refusing service. Concerned that a lack of notice had denied due process to the affected utilities, this court refused to consider such an ex parte application. Moreover, the motion sought extraordinary relief with respect to issues that Congress had already addressed in §366 of the Bankruptcy Code. Section 366 protects a debtor’s access to utility service during the first twenty days after the filing of a bankruptcy petition. Then, on “request of a party in interest and after notice and a hearing, the court may order reasonable modification of the amount of deposit or other security necessary to provide adequate assurance of payment.” 11 U.S.C. §366(b). By its first day motion, the debtor essentially sought to disregard the procedural requirements of §366 for a notice and hearing. Nor was such special relief necessary, in light of the protection of utility access for twenty days. For these reasons, the court denied the debtor’s motion, but without prejudice to a future application under §366.
III. Key Employee Retention and Incentive Program

The debtor next moved for authority to implement a key employee retention and incentive program for non-insider personnel. Specifically, the debtor proposed to offer a bonus to key employees who would remain with the company through the completion of the anticipated sale of the debtor’s operating assets. Contemplating a typical bonus equal to 133 percent of an individual’s bi-weekly pay, the debtor estimated a total cost to the estate of less than $25,000. In support of its request, the debtor represented that it required the services of these key employees; that the debtor had no ability on the short term to replace these key employees; and that in light of the debtor’s precarious financial condition, these employees might accept other employment unless they received sufficient financial incentive to remain with the company.

The retention and incentive program represents the type of operational decision for which this court will generally give reasonable deference to the sound discretion of management. In the present instance, to the satisfaction of this court, the debtor has demonstrated an immediate danger to its personnel requirements and hence, that it has an urgent need for the proposed program. The projected payments appear to be reasonable in amount. The court discerns nothing in the program that would violate any substantive rights of parties in interest. For these reasons, the court granted this first day motion to authorize a key employee retention and incentive program.

IV. Restructuring Consultant

Pursuant to 11 U.S.C. §363(b), Colad asked the court to approve the continued employment of Getzler Henrich & Associates LLC (“Getzler Henrich”) as a restructuring consultant. As part of this engagement, Getzler Henrich will also provide the services of a chief restructuring officer. In its moving papers, the debtor acknowledged that prior to the bankruptcy filing, its secured creditor had requested that Colad retain the services of a restructuring firm. Colad’s president further represented that the debtor needed these consulting services “in order to maximize recovery for all parties in interest.”

This court realizes that the designation of a particular restructuring manager may define the likely course of events in a bankruptcy proceeding. What inferences may be drawn from the fact that the debtor selected the proposed consultant upon the recommendation of the secured creditor? Do past practices reveal a history of recommendations which may have been made in good faith, but which nonetheless follow a pattern that Continental may now prefer? These questions suggest that even though the Debtor and Getzler Henrich signed a management agreement prior to the bankruptcy filing, the continued retention of the firm will involve the use of resources outside the ordinary course of the debtor’s business. Accordingly, the debtor has properly moved for court approval of Getzler Henrich’s appointment.

Section 363(b) provides that a debtor in possession “after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.” By reason of the requirement for notice, this court denied the first day motion for final approval of the retention of Getzler Henrich. Instead, the court approved an interim retention, with direction for final hearing on notice to the twenty largest creditors and others who might request service. At that final hearing, debtor’s counsel demonstrated the need for a consultant and that Colad had
exercised sound discretion in its selection of Getzler Henrich. For these reasons, the court then
gave its final approval to the retention proposal.

V.  Retention of Counsel

In the absence of opposition from the office of the United States Trustee, this court will
normally grant a first day motion for the appointment of counsel for the debtor in possession. In
the present instance, however, the proposed firm had previously represented William J.
Brosnahan, as well as two of the debtor’s creditors on unrelated matters. Section 327(c) of the
Bankruptcy Code provides that such prior representation does not preclude employment by the
debtor, “unless there is objection by another creditor or the United States trustee, in which case
the court shall disapprove such employment if there is an actual conflict of interest.” To allow
creditors to assert any such opposition, this court requires that creditors receive appropriate
notice of the proposed and prior representations. Accordingly, as a first day order, I approved
only an interim appointment of counsel.

VI.  Cash Management System

Prior to its bankruptcy filing, Colad had established a cash management system, which
required the deposit of receipts into a lockbox and the transfer of those funds to Continental, on
account of its secured position. Essentially, this system facilitated the debtor’s revolving credit
agreement, under which Colad would direct all receipts toward payment on account of its
secured obligations and Continental would continuously advance new funds into Colad’s
operating accounts. If continued on a post-petition basis, this arrangement would cause the
gradual but inevitable satisfaction of the debtor’s pre-petition obligation and a corresponding re-
extension of credit with administrative priority. Later in this opinion, I will consider the debtor’s
motion to approve post-petition financing. In a separate first day motion, the debtor sought
authority to maintain its cash management system.

Colad represented to the court that the Office of the United States Trustee was insisting
that the debtor close all existing bank accounts; that it open new accounts in the name of the
debtor in possession; that it maintain a separate account for cash collateral; and that all checks
bear the description “debtor in possession,” as well as the bankruptcy case number and a
designation of the purpose of the account. Arguing that these measures would unduly disrupt its
operations, Colad sought a first day order that would allow it to maintain its pre-petition system
of cash management. Further, Colad represented that at least some payroll checks were still in
float. In light of the first day order allowing payment of priority wage claims, a closing of the
existing payroll account would cause the dishonor of existing checks and would thereby impact
adversely upon the debtor’s relationship with its employees. To the extent that other outstanding
checks would also clear, Colad proposed to preserve any right to retrieve an unauthorized
payment pursuant to 11 U.S.C. §549.

In comparison to the debtor in possession financing agreement, the cash management
system has only tangential significance to the administration of this case. For reasons of
convenience, I granted the debtor’s request to maintain all of its existing accounts, but on
condition that the debtor order new checks indicating Colad’s status as a debtor in possession.
Additionally, I allowed the processing of extant checks, in order to avoid disruption of
relationships with employees who in any event would have claimed priority for the amount of their uncashed checks.

VII. Debtor in Possession Financing Agreement

The most important of the first day motions was the application for authority to obtain post-petition financing. Like most debtors in chapter 11, Colad had pledged nearly all of its assets as collateral to secure a pre-petition credit facility. Among these assets were Colad’s inventory, receivables, and the proceeds of its inventory and receivables, all of which are deemed to constitute “cash collateral,” as defined by §363(a) of the Bankruptcy Code. Pursuant to 11 U.S.C. §363(c)(2), a debtor in possession may not use cash collateral unless either “(A) each entity that has an interest in such cash collateral consents; or (B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.” Hence, without either consent or court authorization, Colad would have had no access to most of the cash that would have been generated through its normal business operations. To satisfy its cash needs, Colad moved under 11 U.S.C. §364 for emergency and final authority to obtain post-petition financing from Continental, the current holder of Colad’s pre-petition loan facility.

Continental and Colad have proposed to link the post-petition financing facility to the debtor’s pre-petition revolver loan. Under their agreement, proceeds of collateral would be applied first to the satisfaction of the balance due on the pre-petition loan. Meanwhile, Continental would fund the debtor’s post-petition activities through new advances under the post-petition facility. Providing that post-petition advances would be secured by all assets of the debtor, the proposed facility would also create an obligation that would receive administrative and super priority status, as allowed under 11 U.S.C. §364(c).

In a competitive and adversarial environment, one cannot fault a creditor for seeking an outcome that will maximize the return for itself. For this reason, this court has often approved the post-petition use of a revolving credit facility. From the lender’s perspective, such an arrangement avoids the various legal problems of cross-collateralization. In a cross-collateralization arrangement, a lender advances new credit on condition that an enhanced set of collateral will secure both pre-petition and post-petition loans. Instead, the revolver arrangement permits a satisfaction of the pre-petition loan, so that an increasing percentage of the lender’s total exposure will receive the security and benefits of the new post-petition credit facility. Although this court will approve a proper-post petition revolver facility, it will not allow a disregard of the procedural and substantive rights of other parties in interest.

Bankruptcy Rule 4001 imposes procedural rules for consideration of a motion for authority to obtain credit. Subdivision (c)(1) of this rule requires that the court treat such a motion as a contested matter under Rule 9014, and that notice of such a motion be served upon the members of the Official Committee of Unsecured Creditors, or if no committee has been appointed, then upon the twenty largest unsecured creditors. In a typical case, this requirement of notice presents practical challenges, in as much as most debtors have an immediate need for financing. For this reason, the following text of Bankruptcy Rule 4001(c)(2) attempts to find a balance that will accommodate both financial necessity and concerns for due process:
The court may commence a final hearing on a motion for authority to obtain credit no earlier than 15 days after service of the motion. If the motion so requests, the court may conduct a hearing before such 15 day period expires, but the court may authorize the obtaining of credit only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing.

(emphasis added). Pursuant to this rule, therefore, the court may consider a first day motion to approve an emergency lending facility, but only if two conditions are satisfied. First, any emergency authorization must be limited only “to the extent necessary to avoid immediate and irreparable harm.” Second, the authorization may be effective only until a final hearing on appropriate notice to creditors as required under Rule 4001(c)(1).

In support of its first day motion for authority to obtain post-petition financing, the debtor represented that it could not operate without a post-petition line of credit and that it had no ability to obtain such credit from any source other than Continental. Conceptually, this Court found that these representations were adequate to justify an appropriate form of emergency lending until the scheduled hearing for final approval. However, in the form that the debtor proposed, the emergency funding order was unacceptable for the following four reasons:

1. The order failed to reflect any effort to limit the conditions of credit only to those which would be absolutely necessary to avoid immediate and irreparable harm. See Bankruptcy Rule 4001(c)(2). Rather, the proposed order would have approved an interim loan agreement with terms essentially identical to those contemplated for the final loan agreement. The only difference between the two agreements was their effective date. Without a showing of any compelling reason for identical terms, the debtor appeared to treat the interim order as a mere formality of procedure on a one-way street to approval of a final order.

2. The interim order was inappropriately complex, and thereby denied to the court a sufficient basis of confidence in the reasonableness of its terms. On an emergency basis, the debtor wanted the court to sign a 26-page order, which incorporated the terms of a loan agreement that filled 93 pages of single space text, including exhibits. This court appreciates the dollar value of the proposed lending facility, and accepts the need for a comprehensive agreement. For this reason, as hereafter discussed, the court has carefully examined the terms of the final loan agreement. A first day order is inherently different, however. Without benefit of opportunities for comment from creditors on notice, the court must view with skepticism the exigent submission of any such complex instrument.

3. Based on its cursory review, the court discovered that the proposed order would change substantive and procedural rights, without allowing any reasonable opportunity for creditor objection. For example, the interim loan arrangement included a grant of relief from the automatic stay in the event of default, limitations on the debtor’s right to propose a plan of reorganization, and a waiver of various claims that the debtor might assert against Continental. Particularly troublesome were the provisions of §11.6 of the Loan Agreement, which purported to require, as a condition for interim funding, the disavowal and waiver of various “rights and remedies provided under the Bankruptcy Code, the Federal Rules of Civil Procedure, and the
Bankruptcy Rules.” Furthermore, paragraphs 2.1 and 11.1 of the Loan Agreement seemingly attempted to grant administrative priority to the pre-petition claims of Continental. Later in this opinion, the court will discuss whether certain of these terms are appropriately included into an order that authorizes lending on a final basis. As part of a first day order, where unsecured creditors have had no opportunity to object, such terms are unacceptable.

4. As originally submitted, the first day lending order proposed to authorize a potential violation of state law and to waive the substantive rights of other creditors without prior notice to them. By its terms, the proposed loan agreement contemplated a post-petition advance of $500,000, for a term of approximately 90 days. In addition to interest at the rate of 4.5 percent over prime, Colad was to pay loan fees totaling in excess of $135,000. Based upon these facts, the court questioned whether the cost of borrowing would exceed New York State’s criminal usury rate of 25 percent. Additionally, the debtor’s proposed order would approve a loan that was conditioned upon a waiver of all marshaling obligations. Without deciding these issues, this court refused on an emergency basis to approve the loan charges or to consider a waiver of rights, where the affected creditors had yet to receive notice of the debtor’s proposal.

At the hearing to consider the debtor’s first day motions, the respective attorneys for Colad and Continental responded to the above concerns, by asserting that the proposed lending arrangement represented the best and only terms available to the debtor. In my view, this position seemed disingenuous. Continental had recently acquired its secured position, with the stated desire to effect a purchase of assets as a going concern under §363 of the Bankruptcy Code. With this objective, Continental would be obviously disinclined to compel a distressed liquidation of its position. As holder of a first lien in the debtor’s inventory and receivables, Continental was positioned to dictate terms. Consequently, the proposed loan did not represent terms negotiated in any form of open market. Although the reality of circumstances might compel acceptance of these terms after a final hearing, this court was unwilling to disregard the above mentioned concerns until at least after the twenty largest unsecured creditors had opportunity to object.

The resolution of the motion for interim financing confirmed the court’s perception of disingenuousness with regard to the assertion that the debtor could obtain no better terms of lending. After this court refused to approve an order in the form that the debtor had first presented, the parties negotiated an arrangement that the court could accept on an interim basis. Ultimately, I signed a simpler order authorizing the debtor to borrow funds needed to pay necessary expenditures. With respect to these advances, the lender received a super-priority administrative expense claim secured by a lien on all of the debtor’s assets. Without rejecting the possibility of eventual approval under the terms of a final lending order, the interim order deferred consideration of the various provisions which the court had found to be troublesome. In particular, the parties agreed that most of the proposed loan fees would be charged not in connection with the interim loan, but only if authorized under the terms of a final loan agreement.

The interim lending order authorized the debtor to borrow funds on an emergency basis, until such time as the court would decide the request to approve a final lending order. As required by Bankruptcy Rule 4001(c), the court also directed that the debtor give to the twenty
largest creditors a fifteen day notice of the hearing to consider a final DIP lending facility. That hearing was initially scheduled for February 24, but on consent of all parties, was adjourned to March 8. A further hearing with respect to the terms of a possible order was then conducted on March 28, 2005.

VIII. Motion to Authorize a Final DIP Lending Facility

The debtor seeks authority to borrow funds under the terms of a final lending facility, whose present form incorporates changes designed to address some of the concerns that the court expressed to the parties at the hearing to approve interim lending. Appointed subsequent to the consideration of interim authorization, the Official Committee of Unsecured Creditors now supports the debtor’s motion for final authority. However, Daniel Williams opposes the request. Primarily, he contends that the proposed facility entails excessive risk, particularly in light of the fact that the debtor’s financial history indicates the improbability of a successful reorganization. The court might give greater consideration to this objection, if the debtor intended to reorganize as a going concern. In the present instance, however, the debtor has candidly indicated an intent to liquidate, most likely through a sale of assets under 11 U.S.C. §363. Thus, the borrowing is designed only to maintain operations as a going concern for the short term, until a sale can be completed. Under these circumstances, the court is prepared to authorize borrowing under terms of an appropriate facility. However, the court cannot approve lending in the form that Colad and Continental have proposed.

In addition to his general opposition, Daniel Williams presented 27 objections to specific terms of the debtor’s lending proposal. Except as stated herein, these objections are overruled. Due to the need for a timely decision, the court will not now comment about those provisions of the lending agreement that are acceptable. Rather, this opinion will discuss five fatal defects that preclude approval of the proposed order in its current form.

A. The proposed order would sanction excessive and usurious interest.

The debtor seeks to borrow a maximum of $494,000.00 for a term of less than ninety days. On this loan, the debtor would pay interest at an annual rate of four and one-half percent over “the Chase Bank Rate.” In addition, however, the debtor would pay a non-refundable loan commitment fee of $50,000, a closing fee of $50,000, collateral management fees of $10,000 at closing and $1,500 per month thereafter, and an unused line fee based on a formula that would be calculated each month. All of these various fees would be deducted from the amount that the debtor proposes to borrow. Thus, the debtor would actually receive operating funds of less than $381,000 dollars. Because the term of the loan is less than ninety days, the fees alone would represent charges equivalent to an interest rate in excess of 100 percent per annum.

New York law exempts corporate borrowings from the penalties of civil usury. N.Y. Gen. Oblig. L. §5-521(1). However, pursuant to General Obligations Law §5-521(3), this exemption does not extend to the prohibitions against criminal usury in Penal Law §190.40. This latter section provides generally that a person or entity commits criminal usury in the second degree when it “knowingly charges, takes or receives any money or other property as interest on the loan or forbearance of any money or other property, at a rate exceeding 25 per centum per annum or the equivalent rate for a longer or shorter period.”
Paragraph 10.6 of the proposed loan agreement would obligate Colad to pay “all out-of-pocket costs and expenses” that Continental may incur. Consequently, the various loan fees do not represent any reimbursement of reasonable costs and expenses. With no evidence of a contrary purpose or effect, the court can only view the fees as the collection of additional interest. See N.Y. Gen. Oblig. L. §5-501(2). Unless some other statutory exception applies, therefore, the proposed loan agreement would violate the criminal usury provisions of New York law.

Subdivision (6)(b) of New York General Obligations Law §5-501 states that the criminal usury statute shall not apply to any loan or forbearance in the amount of $2,500,000 or more. In its application for interim borrowing authority, Colad asked the court to approve an agreement that would allow a loan amount for “up to the maximum of $494,000.” Now, in the application for final borrowing authority, Colad seeks to approve a restructured loan agreement. Although the restructured agreement also seeks a similar advance of new credit, it defines the “Post-Petition Loan Amount” as “up to the aggregate of $3,252,000.00, consisting of (a) the renewal of the pre-petition revolving line of credit and (b) the over-line facility in the amount of $494,000.00…” The issue for this court is whether such wordsmithery and linguistic legerdemain can transform the proposed post-petition loan into a transaction that is exempt from New York’s usury prohibition.

This court believes that it must treat the post-petition advances as a separate loan that is subject to the prohibitions against criminal usury. Section 364 speaks only to court approval of post-petition indebtedness, and not to any ratification of pre-petition obligations. If Continental and Colad had so wanted, they could have proposed a new loan whose proceeds would be used to discharge the pre-petition loan and to fund post-petition activity. For good reason, however, the parties chose to preserve the pre-petition indebtedness. As against other secured debt, the pre-petition loans retain priority that relates to the earlier date of perfection. Accordingly, §11.2 of the proposed loan agreement states that notwithstanding any other provision of that contract, “the pre-petition liens of the Pre-Petition Lender on the Pre-Petition Collateral will remain in full force and effect.” Preservation of the pre-petition debt also serves to avoid the risk of a loss of priority, in the event of a demonstration of bad faith after a reversal on appeal of any lending authorization. See 11 U.S.C. §364(e). Ultimately, the loan restructuring serves only to highlight the transparency of Continental’s purpose and intent. Despite its reference to the pre-petition obligation, the modified loan agreement created a new loan of only $494,000. Section 2.1 of the post-petition loan agreement confirms that the new loan arises not as a continuing advance under the prior agreement, but pursuant only “to the terms of the Pre-Petition Loan Agreement,” and then “as amended and supplemented hereby and by the Bankruptcy Court Order” (emphasis added). This is not an instance in which the debtor seeks to assume a pre-petition agreement which, but for bankruptcy, would have authorized the desired advance of funds. Instead, the post-petition loan represents a new lending facility. Being less than $2,500,000, this new loan falls below any exemption to the applicable law of criminal usury.

At the hearing on the motion for final lending authorization, the debtor presented testimony showing that it was unable to obtain credit on any terms other than as proposed. While such proof may satisfy some of the requirements for the approval of secured and priority credit under 11 U.S.C. §364, the testimony provides no justification for a waiver of defenses under 11
In relevant part, this section states that the bankruptcy estate “shall have the benefit of any defense available to the debtor as against any entity other than the estate, including…usury.” Moreover, pursuant to that section, “[a] waiver of any such defense by the debtor after the commencement of the case does not bind the estate.”

The civil implications of criminal usury are unsettled under New York law. In re Venture Mortgage Fund, L.P., 282 F.3d 185 (2nd Cir. 2002). When a lender other than a bank charges a rate of interest in excess of the civil usury limits, General Obligations Law §5-511 will void the underlying obligation. Here, the proposed loan satisfies civil limitations but would violate criminal prohibitions. Under these circumstances, the statute does not indicate whether the criminal usury violation would similarly void the entire obligation. Nonetheless, the borrower would presumably enjoy at least a defense against collection of excessive interest. Pursuant to 11 U.S.C. §558, this court is obliged to honor such a defense.

This court does not mean to suggest that in extending the proposed credit with court authorization, Continental would have met the scinter requirement of the Penal Law. Under no circumstance, however, will this court authorize acts that would otherwise be criminal under New York law. The bankruptcy process provides no safe haven for criminal activity. In New York, the criminal usury law has as its very purpose the imposition of an absolute cap on interest. For whatever reason, the New York legislature has decided that an interest limit of 25 percent per annum will apply to transactions of less than $2,500,000, even when the statute will cause a denial of all credit. Because the proposed loan would violate criminal usury if extended outside bankruptcy, this court will not now authorize its proposed terms.

This court must also reject the proposed loan fees for a second independent reason. Even if the proposed transaction could overcome a usury defense, the fees serve as an inappropriate subterfuge to avoid the requirement for a commercially reasonable disposition of assets under U.C.C. §9-610.

By its terms, the revised loan agreement contemplates a sale of the debtor’s assets to Continental. Having recently acquired its secured position by assignment from the prior lender, Continental will make a credit bid for those assets. If it had elected to exercise the rights of a secured creditor under article 9 of the Uniform Commercial Code, Continental would have been required to fulfill the mandate of §9-610(b)…In relevant part, this section provides that “every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable.” Outside bankruptcy, the amount of Continental’s credit bid would include only the balance due on its outstanding loan facilities, including any costs recoverable under the loan agreement. Now, Continental proposes to enhance the amount of that credit bid with loan fees totaling at least $113,000.00. Such an enhancement can only work to chill the prospects for competitive bidding. Any such chilling effect will jeopardize the possibility of a surplus that might inure to the benefit of unsecured creditors.

Interest and loan fees in any amount will necessarily reduce the surplus from the sale of secured assets. If proposed in isolation from the contemplated sale of assets, the loan might not be subject to the same criticism. But Continental acquired its current position in contemplation of an asset purchase. Now Continental proposes loan fees that can only serve to facilitate its desired
acquisition, all to the possible detriment of any competing bid. These fees represent no “out of pocket” cost to the lender. In my view, such machinations would be commercially unreasonable outside bankruptcy. Investors may not use the bankruptcy process to obtain respectability for otherwise suspect efforts to influence a bidding process. Accordingly, the court will not approve the proposed loan fees in the present instance.

B. The debtor offers insufficient justification for a priming lien.

The debtor seeks an order which would give to Continental a priming lien over all other secured creditors. In my view, however, the present circumstances do not justify such relief under the applicable standard of 11 U.S.C. §364(d)(1):

The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if—(A) the trustee is unable to obtain such credit otherwise; and (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

In the present instance, Continental seeks the benefit of a generalized priming as against the positions of all other secured creditors. However, the moving papers fail to identify any secured creditors whose liens would be primed. Under these circumstances, a priming lien of any kind would be inappropriate for two reasons. First, the notice requirement of §364(d)(1) must necessarily inure to the benefit of superior lienors. Without an identification of those superior lienors, the court cannot possibly confirm the adequacy of notice. The debtor has satisfied the requirements of Bankruptcy Rule 4001, which mandates notice either to the twenty largest unsecured creditors or to a committee appointed under 11 U.S.C. §1102. This notice, however, does not necessarily reach the holders of secured debt. Seeking to modify the rights of parties in absentia, the generalized priming lien cannot possibly satisfy the notice requirements of §364(d)(1). Second, as required by §364(d)(1)(B), in order to grant a priming lien, the court must make a finding of adequate protection of all senior or equal interests. With no identification of those interests, the court cannot begin to assess the adequacy of protection. Contrary to the mandate of 11 U.S.C. §364(d)(2), therefore, the debtor has failed to meet its burden of proof on this issue.

C. The debtor proposes an impermissible modification of the rights of third parties.

Any extension of secured credit will usually impact the interests of other creditors. In bankruptcy, the court may authorize the debtor to exacerbate this impact in several narrowly defined ways. For example, under §364(c) of the Bankruptcy Code, the court may grant priority over other administrative creditors. As noted earlier in this opinion, §364(d) permits a priming lien in certain limited circumstances. Generally, however, the Bankruptcy Code gives to post-petition secured creditors only the same rights that a secured creditor could acquire outside bankruptcy. Unless the Bankruptcy Code expressly provides, this court has no power to diminish the rights of third parties as against a secured creditor.
Colad has asked the court to approve an order which provides that Continental “will not be subject to the equitable doctrine of marshaling” or any other similar doctrine with respect to any of the Collateral.” Conversely, §11.7 of the proposed loan agreement would preserve Continental’s right to seek the equitable remedy of marshaling for its own benefit. These contrasting provisions obviously violate the maxim, that one who seeks equity must do equity…But more fundamentally, equitable principles like marshaling have potential application to every secured indebtedness. While the debtor may seek authority to waive its own rights, it cannot waive the marshaling rights of parties who have not consented and may not even have received notice of the debtor’s motion. Under the present procedural circumstances, this court can discern no basis to eviscerate the equitable doctrine of marshaling.

D. The debtor proposes an inappropriate modification of statutory rights and obligations in bankruptcy.

The debtor and its secured creditor do not constitute a legislature. Thus, they have no right to implement a private agreement that effectively changes the bankruptcy law with regard to the statutory rights of third parties. In three important respects, Colad and Continental have proposed terms that would impermissibly modify the laws and rules of bankruptcy.

First, the proposed order would prohibit any surcharge of collateral under §506(c) of the Bankruptcy Code. This section provides that a trustee “may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim.” For example, if a sprinkler system extinguishes a fire that would otherwise have destroyed Continental’s collateral, §506(c) would allow the trustee to recover the resulting water bill. Instead, Colad and Continental would either deny the means to pay such charges, or would impose such costs on funds available for distribution to unsecured creditors. By its language, §506(c) speaks only to the payment of reasonable and necessary costs. This court can discern no basis to allow a secured creditor to ignore its application.

Second, to the detriment of any future trustee, the proposed order would change the procedural requirements for stay relief. Section 362(d) of the Bankruptcy Code provides that the court may grant relief from the automatic stay “on request of a party in interest and after notice and a hearing.” Instead, the proposed order would create a default procedure, whereby the stay would automatically lift upon a failure by any interested party to demand a hearing within five business days following notice of an event of default. To the extent that the debtor and creditors’ committee consent, this court would approve such a procedure for purposes of notice to the consenting parties. However, the court will not sanction a waiver of the controlling standard for a hearing on notice to any trustee that may hereafter be appointed.

Third, the proposed order would repudiate the provisions of 11 U.S.C. §546(a), which sets time limitations for commencement of an action to enforce the avoiding powers of sections 544, 545, 547, 548, and 553 of the Bankruptcy Code. Pursuant to §546(a), unless a case is sooner closed or dismissed, the trustee may commence any avoidance action within the latter of two years after the entry of an order for relief, or one year after the appointment or election of a first trustee within the period of two years after entry of an order for relief. Instead, paragraph
26 of the proposed order would more severely limit the commencement of an avoidance action. For example, it would provide that upon conversion of the case to chapter 7, the trustee would be compelled to commence any avoidance action within the earlier of sixty days after appointment or 30 days after delivery of various documentation. Bankruptcy Rule 9006 allows an enlargement or reduction of many of the time limits in the Bankruptcy Rules. However, §546(a) is a statute, not a rule. Consequently, this court lacks authority to approve the shorter time limits that Continental would impose.

E. The proposed order includes a finding of good faith that the parties have yet to establish on the record.

Section 364(e) of the Bankruptcy Code provides generally that a reversal or modification on appeal of an order authorizing secured debt “does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith…” For this obvious reason, the debtor has proposed an order which includes a finding that Continental is extending credit in good faith. At the hearing on this motion, the debtor offered only one witness and his statements about good faith were conclusory. Moreover, the order’s other defects cause uncertainty about intent, particularly with respect to any attempt to discourage competitive bidding. Any finding of good faith is more appropriately made with the benefit of testimony and argument after a reversal or modification on appeal. This is not to say that the debtor would not be able to establish good faith at a future hearing. At this time, however, the court simply lacks an adequate basis to reach any conclusion about Continental’s good faith.

IX. Conclusion

For the reasons stated above, this court will not approve the form of the debtor’s proposed order. Nonetheless, the court would sign an appropriate order authorizing a post-petition loan that avoids the various defects identified herein. With hope that the parties will negotiate the necessary changes, I will continue the interim financing authorization until further order of the court.

So ordered.
CHAPTER 12
BANKRUPTCY ISSUES FOR LANDLORDS AND TENANTS

Consider DebtorCo, which filed for relief under chapter 11. DebtorCo owns an office building that it leases to TenantCo. DebtorCo also occupies a factory building under a five-year lease from LandCo. DebtorCo is, therefore, both a landlord and a tenant. DebtorCo’s Chapter 11 calls both these relationships into question. Must DebtorCo continue to pay rent to LandCo? May LandCo evict DebtorCo? May TenantCo walk away from its lease? May DebtorCo evict TenantCo?

The Bankruptcy Code addresses these questions in §365. The core rule of §365 is deceptively simple: the debtor may assume (elect to retain) or reject (elect to terminate) any unexpired lease. But this is only the beginning. Taken as a whole, Bankruptcy Code §365 is one of the most complicated in the Bankruptcy Code, replete with special interest provisions and exceptions to the general rules. Although this chapter focuses on real estate leases, we note that §365 also covers leases of personal property as well as other “executory contracts.” These are covered in the next chapter.

The Basic Rules

Bankruptcy Code §365 says the debtor may “may assume or reject” an unexpired lease. A motion to assume or reject requires court approval, but in practice the standard is a fairly deferential one—most often articulated as a “business judgment test.”

Assumption of the lease is, essentially, a decision to retain the lease. Rejection of the lease is essentially a decision to terminate the lease. If the debtor-tenant rejects the lease, the landlord may assert a “rejection damage” claim.

If the debtor is in default at the time of filing, the debtor may not assume the lease unless it can cure defaults, compensate the other party for “actual pecuniary loss” caused by these defaults, and provide adequate assurance of future performance under the lease.

Assumption or rejection is one issue. A less obvious wrinkle is that the debtor who can assume a lease may also be able to assign it—transfer it to a third party. See §365(f). This right will over-ride an anti-assignment provision in the lease. And that is not all: unlike an ordinary assignment, a bankruptcy assignment will terminate the obligation of the original assignor, i.e., it works as automatic novation in favor of the debtor. See §365(k).

A debtor-landlord may also assume or reject a lease, but there are special provisions (discussed below) to protect tenants under such circumstances.

What Leases Are Governed by Bankruptcy Code §365?

Bankruptcy Code §365 refers to “unexpired leases.” Thus in order to fall within the scope of this section, the transaction must be both a “lease” and “unexpired.”
You may think the issue of whether a transaction is a lease is beyond dispute. Landlord rents space to tenant for a term of years, with periodic payment of rent under a document entitled “Lease”—end of question. Right? Usually, yes—but not always. Look out for those agreements denominated as leases that are subject to “recharacterization” as something else—perhaps a sale of the property dressed up as a lease, or a secured lending transaction. Bankruptcy courts are not bound to treat a transaction as a “lease” just because it says its one.

What about the “unexpired” question? The problem tends to arise when the debtor is tenant and is trying to hold onto the leased property. If the debtor files while the lease is “unexpired,” then the bankruptcy court can deal with it; otherwise not. If a lease has terminated by its terms before the bankruptcy filing, then there is nothing to assume (or reject). But suppose we are in the fourth year of a ten-year lease. The tenant is behind on the rent. The landlord has declared a default and sent a notice of termination. Is that notice sufficient to “terminate the lease” so that there is nothing left to assume?

This question will be governed by the terms of the lease and state law. For example, in some states there is a “redemption period” that allows the tenant to cure defaults even after a notice of default (or acceleration or termination) of the lease is sent. And some courts have held that until this period expires, the debtor retains an interest in the lease. All such issues go to the question of whether the lease is “unexpired.” These are questions (though they arise under state law) to be decided by the bankruptcy judge.

**Time For Assumption or Rejection When Debtor is Tenant**

Consider this case: DebtorCo is a lessee and files for Chapter 11 with a lease still “unexpired.” The debtor may (with the approval of the court) either assume or reject. Which should it do? The stakes are easy to define. If it “assumes,” then the DIP may remain in possession of the property but the lease becomes a post-petition liability, with all its conditions, and the landlord has a kind of first-priority claim. If the DIP rejects, it has to turn back the property, and the landlord has no more than an unsecured claim for any shortfall (maybe not even that—see discussion of the damage cap, below).

The practical answer is that the DIP will want to do whatever maximizes the value of the estate. The problem DIPs often face is that they don’t know what decision will maximize value until well into the chapter 11 case, and yet the deadline to assume or reject comes early in the case.

A DIP must assume or reject a lease of nonresidential real property, under which the debtor is the tenant, within 120 days after the entry of an order for relief (in a voluntary case, that’s the petition date) or the date of plan confirmation, whichever comes first. §365(d)(4)(A)(i). If the debtor fails to assume or reject within that period, the lease is deemed rejected. The 120-day period may be extended for 90 days in order to allow the DIP enough time to make an informed decision whether to assume or reject. But the extension is not automatic. The DIP must obtain an order granting the extension, and the extension order must be entered before the period for assumption or rejection expires.
If the court grants an extension under 365(d)(4)(i), the court may grant a subsequent extension beyond 210 days from the order for relief only upon prior written consent of the lessor in each instance. See §365 (d)(4)(B)(ii). These provisions, and in particular the requirement of lessor consent for any extension beyond 210 days, are newly enacted as part of BAPCPA. There has been some suggestion that the lessor’s consent must be reasonably granted, but the reasonableness requirement is not found in the statute itself, and it is not yet clear if the bankruptcy bench will stoop to this ploy to provide flexible relief from the rigid time limits imposed by Congress.

The extension can be important for the debtor. A DIP often wants to wait to see how its case will turn out before making the assumption or rejection decision. If it will end up in liquidation, it will probably want to reject its leases. If it is going to reorganize, it will likely want to keep its leases, unless the lease is above market or its post-reorganization business plan does not require this space. If it is going to do a going concern sale, it may want to be able to offer the lease to its buyer.

And even in a liquidation, depending on the market the DIP may be able to sell (“assume and assign”) a lease it has no need for. The DIP is usually able to make a better informed decision after some time passes and it sees in what direction its case is headed. And there are adverse consequences for making the wrong decision. Reject too soon, and you will have lost the lease. Assume too soon (and then decide in retrospect that you should have rejected), you can still reject but the landlord’s claims will have administrative priority (for up to two years’ future rent) rather than general unsecured status.

For these reasons, courts are often willing to extend the DIP’s time to assume or reject up to the limits. Exceptions to this include situations where the landlord can show prejudice as a result of the delay that outweighs the DIP’s need for an extension, or cases where the DIP is not making progress in its reorganization process. The landlord is free to move the court at any time to set a deadline for assumption or rejection of the lease. Such a motion is probably most commonly granted when the DIP is in post-petition default under the lease, but there are other situations where the landlord may be able to demonstrate that the DIP’s failure to make a prompt decision would prejudice the landlord.

The 120-day time limit and extensions are governed by §365(d)(4).

Obligations Pending Assumption or Rejection

The DIP-tenant must comply with its obligations under the lease pending assumption or rejection. See §365(d)(3). The court may grant the DIP temporary deferral of its obligations under the lease during the first 60 days of the case, but the court may not defer those obligations past the 60th day.

The landlord also must comply with its obligations under the lease. A failure to do so could be a breach of contract and/or possibly a violation of the automatic stay.
**Assumption**

If the DIP wants to retain the lease, it will move to assume it. In order to assume the lease, the DIP must cure most defaults or provide assurance that it will promptly do so. See §365(b)(1)(A). Excepted from the core requirements are non-monetary defaults that are impossible to cure and penalties associated with these defaults. See §365(b)(1)(A) and (b)(2)(D). The DIP must also compensate the landlord for “any actual pecuniary loss” resulting from the debtor’s breach. See §365(b)(1)(B). And the debtor must “provide adequate assurance of future performance.” See §365(b)(2)(C).

**Rejection**

If the DIP does not want to retain the lease, then it may reject the lease. If the DIP rejects the lease, it must vacate the space. (This sometimes leads to issues about what the DIP tenant can take with it and what it must leave—this issue is beyond the scope of this chapter, but you should be aware of the issue—which is resolved with reference to state law). If the DIP-tenant rejects the lease, the landlord may assert a “rejection damage” claim, which (unless the lease was previously assumed) will be a pre-petition unsecured claim—sharing pro rata with other general unsecured creditors.

However, unlike other rejection damage claims, landlord’s rejection damage claims are capped by §502(b)(6). The cap is the greater of (i) one year’s rent, or (ii) 15 percent, not to exceed three years, of the rent for the remaining term of the lease. Keep in mind that this is just a cap—the landlord is not automatically entitled to these damages, and in some cases it will not be entitled to any claim at all (for example, if it is able to re-rent the space at a rent that will cover all its losses resulting from rejection).

The cap applies only to future rent that would have been due but for rejection. Any unpaid pre-petition rent would be a claim in addition to the capped amount, and any unpaid post-petition rent would be an administrative priority claim (again, in addition to the capped rejection damage claim).

**Assumption and Assignment**

A final option available to a debtor is to “assume and assign a lease.” Assume the following: the DIP has a warehouse lease in Los Angeles with a ten year remaining term, at $6 per square foot. The market rate for comparable space is $11 per square foot. The DIP’s business strategy is to stop doing business on the West Coast. So the DIP does not need the LA warehouse space. It could, of course, reject the lease. That would make the landlord happy, since it could re-rent the space for $5 per square foot more.

But the DIP can also “assume and assign,” or sell, the lease to another tenant. The other tenant may pay substantial amounts to purchase the below-market lease. This presents an opportunity for the DIP to make some money from a lease that it doesn’t need. (The possibility to do this also sometimes results in an agreement between the DIP and landlord, whereby the
landlord would pay the DIP to reject the lease—the landlord is then free to re-lease the space to a tenant of its choice).

The DIP can make this assignment despite the anti-assignment provision that the lease may contain. In order to assume and assign, the DIP (and assignee) must cure defaults and provide adequate assurance of future performance by the assignee, again except for non-monetary defaults that are impossible to cure all penalties associated with them. The Bankruptcy Code permits the landlord to require a deposit or other security from the assignee equal to what it would have initially required from a similar tenant at the time it entered into the lease. See §365(l).

**What if the Debtor is the Landlord?**

The DIP-landlord also has the right to assume or reject a lease, but the Bankruptcy Code contains a special protection for non-debtor tenants, so that a DIP landlord cannot “reject the tenant out onto the street.”

Bankruptcy Code §365(h) provides that if the debtor-landlord rejects a real estate lease, the non-debtor tenant has two choices—treat the lease as terminated or remain in possession and retain its rights under the lease. If the tenant elects to remain in possession, it must continue to pay rent pursuant to the lease. If the landlord has failed to perform its obligations under the lease, the tenant may offset any damages it has incurred as a result of such non-performance against the rent, but other than such offset the tenant is precluded from asserting claims against the DIP-landlord (that is the trade-off for the right to, in effect, ignore the DIP-landlord’s rejection of the lease).

**Special Provisions for Shopping Center Leases**

Shopping center lessors have some additional protections that other lessors don’t have. These provisions, found in §365(b)(3), provide that “adequate assurance of future performance” of a shopping center lease will include: (1) assurance that the reorganized debtor (or assignee of the lease, if the lease is to be assumed and assigned) will have at least the same ability to pay the rent as the initial lessee, (2) any “percentage rent” will not decline substantially (shopping center leases often provide that a part of the rent is dependent on the tenant’s revenues), (3) assumption of the lease will be subject to requirements in the lease concerning matters such as radius requirements, use of the premises, and exclusivity provisions—common provisions in shopping center leases—and will not breach any other lease, financing agreement or master agreement relating to the same shopping center, and (4) assumption or assignment of the lease will not disrupt any tenant mix or balance in the shopping center.

These provisions are justified in part because of the impact on other tenants. What goes on in one store in a shopping center may well affect the other surrounding stores. For example, let’s say one tenant in a shopping center is an ice cream parlor. The ice cream parlor’s lease may prevent the landlord from leasing other space in the same shopping center to a competing ice cream parlor. It may also prevent the landlord from leasing space to an adult entertainment
business (mom and dad won’t want to take the kids to the ice cream parlor if it’s next door to the X-rated theatre).

Maybe the shop next door is a sporting goods shop. That would be ok with the ice cream tenant. But if the sporting goods store files bankruptcy and tries to assign the lease to another ice cream shop, or an adult-themed shop, the tenant next door could be harmed, and the landlord will find herself involuntarily in breach of the ice cream parlor’s lease. This is the sort of thing §365(d)(3) is mean to prevent.

There is a mix of case law on the issue of how strictly the courts must, or should, enforce these provisions. On the one hand, many courts will feel bound by the law as written, and in any event will appreciate the impact that loose enforcement of these provisions may have on landlords and other tenants. On the other hand, sometimes modest leeway is necessary in order for the debtor to realize substantial value, particularly where granting such leeway will not have any significant impact on the landlord or any other tenant. So courts may show some modest flexibility here, depending on whether the harm complained of by the landlord seems real or, on the other hand, just seems like an effort to gain some leverage over the debtor or its proposed assignee.

**Can a Landlord Protect Itself?**

Much has been written about ways that a landlord can try to protect itself against the risk of rejection by a DIP-tenant. We have space here for only a few thoughts. First, landlords will often require security deposits. This will make the landlord a secured creditor in the tenant’s bankruptcy case (to the extent of the deposit) and improve the landlord’s recovery, although courts have held, based on the legislative history of Bankruptcy Code §502(b)(6), that if a lease is rejected the landlord’s security deposit will protect it only to the extent of the capped claim amount. The same rule may apply to security deposit substitutes like stand-by letters of credit, although the case law is not uniform on this issue.

Another option is to obtain a guarantee of the lease by a third party. That will give the landlord someone else to look to if the tenant files bankruptcy, and courts have held that if the guarantor is not in bankruptcy, the landlord’s claim against the guarantor will not be capped by §502(b)(6), even though its claim against the bankrupt tenant is so capped.

Some landlords also try to define in the lease what would be required for a tenant to demonstrate “adequate assurance of future performance” under a lease, in the event that the tenant becomes subject to bankruptcy proceedings and seeks to assume (or assume and assign) the lease. It is not clear that this will work—the bankruptcy court may not feel bound by the parties’ pre-petition agreement regarding what constitutes adequate assurance (particularly if the requirements are onerous), but reasonable requirements agreed to in advance in the lease may at least be persuasive to the judge in a subsequent dispute over adequate assurance.

Once the tenant is already in bankruptcy, the landlord will want to monitor the tenant’s compliance with the lease terms carefully. If the tenant commits a post-petition breach of the lease, the landlord may want to seek relief from the automatic state to terminate the lease and/or ask the court to fix a prompt deadline for the debtor to assume or reject the lease.
APPENDIX 12(a)
IN RE STANDOR JEWELERS WEST, INC.

The following case illustrates the process of assumption and assignment of a lease and highlights the critical business issue: who gets the value of the “bonus rent” and can it be allocated prepetition, in the lease?

129 B.R. 200 (9th Cir. BAP 1991)

I. Overview

Appellant South Coast Plaza appeals the bankruptcy court determination that Bankruptcy Code §365(f), 11 U.S.C. §365(f), preempts a provision in a retail lease that might otherwise be valid under state law. Appellant argues that the bankruptcy court erred by not determining whether the estate owned the appreciated value of the leasehold before applying §365(f). We affirm.

II. Facts

On June 1, 1990, Debtor Standor Jewelers West, Inc. filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. At the time, Debtor operated four retail jewelry stores including a store leased at the South Coast Plaza Mall in Costa Mesa, California. On July 30, 1990, sought to assume and assign the lease for its South Coast Plaza Store (the “Lease”) and to sell the assets of the South Coast Plaza Store free and clear of liens, with liens to attach to proceeds, to Sterling Inc., an Ohio corporation (“Sterling”). South Coast Plaza objected to the assumption and assignment of the Lease because of debtor’s alleged refusal to provide it with “adequate assurances” that it would comply with a provision in the Lease requiring the lessee to remit to the landlord 75 percent of the appreciation in value of the Lease as a condition to the landlord’s consent to any assignment.

The bankruptcy court held that, even if the provision of the Lease allocating 75 percent of the value of the leasehold to the landlord as a condition of the assignment was valid under state law, that provision constituted a restriction on transfer of the lease which was preempted by and

1 The purchase price for the South Coast Plaza store was allocated by Sterling as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$200,000.00</td>
</tr>
<tr>
<td>Inventory (90 percent or cost)</td>
<td>$250,000.00</td>
</tr>
<tr>
<td>Furniture and Fixtures</td>
<td>$140,000.00</td>
</tr>
<tr>
<td>Covenant not to Compete</td>
<td>$300,000.00</td>
</tr>
<tr>
<td>Intellectual Property</td>
<td>$50,000.00</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$940,000.00</td>
</tr>
</tbody>
</table>
invalid pursuant to §365(f). The court further held that the Lease was an asset of the bankruptcy estate and, as such, South Coast Plaza had no entitlement to any part of the $350,000.00 allocated by Sterling to the Covenant Not to Compete and to Intellectual Property.² South Coast Plaza timely appealed.

III. Issue Presented

We must determine whether a lessor’s condition on transfer of a lease, providing for the lessor to be paid a substantial portion of the lease appreciation, may be held invalid under §365(f) as a restriction on the ability of the debtor to assign its interest in a lease.

IV. Standard of Review

The Bankruptcy Appellate Panel reviews the bankruptcy court’s findings of fact for clear error and its conclusions of law de novo. Bankruptcy Rule 8013; Ragsdale v. Haller, 780 F.2d 794, 795 (9th Cir. 1986).

V. Discussion

Pursuant to the Bankruptcy Code, a debtor in possession enjoys all of the rights, powers and duties of a trustee. 11 U.S.C. §1107. Among the powers of a debtor in possession is the right to assume and assign an unexpired lease pursuant to 11 U.S.C. §365. In order to facilitate the assignment of unexpired leases, §365(f)(1) renders unenforceable provisions in a lease which condition or in any way restrict the assignment of the lease:

…notwithstanding a provision in an…unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease…


In In re National Sugar Refining Co., 21 B.R. 196 (Bankr. S.D.N.Y. 1982), the court invalidated provisions in a lease which required the debtor to transfer a portion of the purchase price to the lessor.³ South Coast Plaza attempts to distinguish National Sugar Refining by

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² South Coast Plaza contends that debtor deprived it of its interest in the leasehold estate by not allocating any of the purchase price to the Lease (see note 1, infra). Pursuant to §10.01(b) of the Lease, South Coast Plaza contends that the $350,000.00 allocated to intangibles is attributed to leasehold appreciation. Accordingly, South Coast Plaza claims that it is entitled to $262,500.00 of the $350,000.00 held by the debtor in the constructive trust.

³ The provision under review in National Sugar Refining is virtually identical in effect to §§10.01(e) of the Debtor’s lease with South Coast Plaza.
claiming that the court in that case misunderstood that it must first determine whether the provision validly allocated the ownership interest under state law. South Coast Plaza contends that in the instant case, the bankruptcy court erred by not initially determining who owns the property at issue: the 75 percent of the appreciated leasehold estate. In order to do so, South Coast Plaza argues that the court must refer to state law and the language of the Lease.

Under applicable California law, parties to a commercial lease are permitted to condition assignment of that lease upon payment to the landlord of some or all of any consideration the tenant receives upon assignment in excess of the rent provided in the lease. See California Civil Code §1995.240 (1991 Supp.), Kendall v. Ernest Pestana, Inc., 40 Cal. 3d 488, 220 Cal. Rptr. 818, 829 n.17, 709 P.2d 837 (1985). However, the bankruptcy court rejected this reasoning and found National Sugar Refining controlling, concluding that because the Lease is an asset of the estate pursuant to §541, restrictions on its transfer are invalid pursuant to §365(f).

In In re Howe, 78 B.R. 226 (Bankr. S.D. 1987), the court struck down a provision in an executory contact which provided that the vendor would consent to an assignment if the debtor paid a 4 percent assumption fee. The court stated:

> It is clear from the language of the contract that [vendor’s] consent to assignment is directly conditioned on its receipt of the four percent assumption fee…

> Therefore, Section 365(f)(1) governs this matter and precludes enforcement of the four percent assumption fee required in the contract for the deed.

78 B.R. at 230. The court further added that to the extent the 4 percent assumption fee represented “an attempt by the vendor to extract any profit realized upon the assignment of the contract…Such a purpose would frustrate the Congressional policy of assisting the debtor in realizing the equity in all his or her assets…[and] would result in a windfall to the vendor” in contravention of Congressional policy. Id. at 230 n.7.

The court in National Sugar Refining stated:

> The clear language of §36.01 of the Lease prohibits [the Debtor] from assigning the Lease without [the landlord’s] consent. §36.02 of the Lease, which applies only to consensual assignment, provides that as a condition precedent to obtaining [the landlord’s] consent to an assignment, [the Debtor] must offer to surrender the premises to [the landlord]. If [the Debtor’s] offer to surrender is refused by [the landlord]…[the landlord] has the right to request the profits realized by [the Debtor] upon an assignment.

21 B.R. at 198.

Compare: Paragraph 10.01(e) states in pertinent part:

> As a condition to Landlord’s consent to any assignment or subletting, Landlord shall be entitled to receive, in the case of an assignment, 75 percent of all consideration given, directly or indirectly by the assignee to tenant for tenant’s leasehold interest hereunder. (Emphasis added.)
We find this reasoning persuasive. In this case, enforcement of §10.01(b) and (e) of the Lease will favor the Landlord by conditioning and restricting assignment of the Lease. Consequently, the enforcement of the allocation provision in §10.01(e) would adversely affect the ability of the debtor in its rehabilitation effort in contravention of §365(f).

VI. Conclusion

Pursuant to §365(f) of the Bankruptcy Code, a provision which conditions or restricts the ability of a debtor to fully realize the economic value of its lease upon assignment is invalid. Accordingly, the bankruptcy court order denying South Coast Plaza’s claim to 75 percent of the appreciated value of the leasehold estate upon assignment is AFFIRMED.
CHAPTER 13
EXECUTORY CONTRACTS AND SECTION 365

Bankruptcy Code §365(a) provides that “the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.” These words are seemingly simple and straightforward, bellying the complexity of §365.

This section is long. It is rife with special interest legislation. Case law is mixed in interpreting its various subsections. And, even the term “executory contract” is more complicated than it appears at first blush.

The term “executory contract” is not defined in the Bankruptcy Code. It may seem intuitive—but on a moment’s reflection, we can see that it cannot mean what it means outside bankruptcy. That is: at state law, an “executory contract” is any contract unperformed on either side. Apply this to bankruptcy, and every creditor’s claim becomes an executory contract.

This would suggest that the trustee may pick and choose which claims to assume and which to reject. But the whole idea of bankruptcy is that we deal with claims pro rata. Picking and choosing is so far from pro rata that the drafters must have been thinking of something else.

Faced with this perplexity, a lot of courts have fallen back on a definition that we associate with the late, great Professor Vern Countryman—the so-called “Countryman definition,” which holds that an “executory contract” is

[A] contract under which the obligation of both the bankrupt and the other party to the contract is so far clearly unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other.

Countryman, Executory Contracts in Bankruptcy: Part I., 57 Minn. L. Rev. 439, 469 (1973) (italics added). This oft quoted definition is somewhat broadly applied in practice as if it reads “a contract with unperformed duties on both sides.” Thus, for example, a non-exclusive patent license has been held to be an executory contract because royalty payments were due from the licensee and the licensor had the duty to refrain from bringing a meritless infringement action. But the key is to look for (material) duties on both sides.

Consider a deal in which the seller agrees to deliver a load of widgets every month for a year, the buyer to pay 10 days after delivery. Suppose the seller suspends delivery after three months, or suppose the buyer stops paying. Breach by either would seem to excuse the other from his obligation. This case, at least, seems to fit the Countryman definition.

It seems reasonably clear what Countryman was up to. He wanted to distinguish “executory contract” (on one side) from “security interest” on the other. To see why this is important, consider the case of a transferor who transfers a widget to a transferee in exchange for
a promise to pay a million dollars. The buyer takes possession but then files bankruptcy without paying. Suppose also that the widget, at the time of filing, is worth only $600,000.

What are the rights of the parties? If the deal is a security agreement, the rights are tolerably clear. The transferor/seller has first dibs on the widget, and retains a deficiency claim for $400,000.

If the debtor is in chapter 11, then the DIP may do more: he may “rewrite the contract” and impose a new deal on the secured creditor, binding so long as it has a present value of $600,000. For example: suppose the debtor offers 10 payments of $81,500, discounted at six percent. The present value of this payment stream is $600,000. If 6 percent is the “right” rate, then the court can impose the plan on the secured creditor. For the moment, the point is that the court can’t do anything of the sort if the deal is an executory contract, even though the economics may be the same.

If the deal is an executory contract, the rights are equally clear and dramatically different. The DIP may assume or reject. But “assume” means “assume in toto”—assume the contract with all its attendant obligations, and without any power to modify or rewrite it. Or it must “reject in toto,” which means he must give back the property (for any shortfall there remains an unsecured claim).

Which should the DIP do? The answer to that question ought to depend on the value of the deal. If the contract is burdensome to the estate, he ought to reject (Countryman taught us to think of it as an analog to abandoning worthless property). If it is a benefit of to the estate, he ought to assume or even (as we shall see below) assign it to a third party.

The DIP has to act within the realm of “business judgment” in deciding whether to assume or reject, but the courts aren’t eager to second-guess him. Even within “business judgment,” though, the DIP cannot assume on whim. Instead, he must follow the dictate of §365(b):

If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee:

(a) cures, or provides adequate assurance that the trustee will promptly cure, such default [other than an incurable non-monetary default];

(b) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(c) provides adequate assurance of future performance under such contract or lease.
The devil is in the details here: a fair amount of bankruptcy litigation, and a great deal of knuckle-crunching negotiation, occurs in the realm of “cure, compensate, and assure.”

How soon must the DIP decide whether to assume or reject? Bankruptcy Code §365(d)(2) says that in chapter 11, “the trustee may assume or reject an executory…at any time before the confirmation of a plan.” But it adds: “the court, on the request of any party to such contract …., may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.” (Don’t confuse this rule with the time limits on real estate leases, which are covered by §365(d)(4) and are discussed in Chapter 12 of this book.)

The practical effect of this rule is to put the ball in the non-debtor’s court. If he is tired of waiting for the DIP to assume or reject, it is he who must ask the court to compel an earlier determination. In the interim before assumption or rejection, the parties are to perform the contract and the failure of the debtor to do so may give rise to an administrative expense claim.

It is one thing to assume the executory contract; quite another to assign it to a third party. Remarkably, the Bankruptcy Code provides both. See §365(f). To assign, the DIP must first assume the contract, including curing defaults. Then he must provide “adequate assurance of future performance by the assignee.” Note that in the case of assignment, “adequate assurance” is required regardless of whether there has been any default under the contract.

Not every contract is eligible for assumption and assignment. Bankruptcy Code §365(c), for example, prohibits assignment where “applicable law” excuses a party “from accepting performance from or rendering performance to an entity other than the debtor.” Think personal service contracts. If Metallica were to go into bankruptcy, you wouldn’t want Ozzfest to have to accept performance from Barbara Streisand (though at least one of us assumes that Ms. Streisand would be honored to be given the opportunity).

The Bankruptcy Code seems also to say that if the contract cannot be assigned, it cannot be assumed. In chapter 7, perhaps this makes sense: you wouldn’t want the trustee striding onstage. But suppose Metallica files for relief under chapter 11, and remains as debtor in possession. You might not think that the Bankruptcy Code would prohibit its assumption of its own deal. But it may: in an important series of cases, the courts have used just such reasoning to prevent the assumption of an intellectual property agreement. In re Catapult Entertainment, 165 F.3d 747 (9th Cir. 1999); In re Catron, 158 B.R. 629, 633 (E.D. Va. 1993), aff’d without opinion, 25 F.3d 1038 (4th Cir. 1994); In re James Cable Partners, 27 F.3d 534, 537 (11th Cir. 1994); In re West Electronics Inc., 852 F.2d 79, 83 (3rd Cir. 1988).

If the DIP assumes an executory contract, the counterparty has all the rights he had before bankruptcy, and a bit more: the counterparty has an administrative claim against the estate, or a post-discharge claim against the reorganized debtor.

Note that assumption or rejection must be done “subject to the court’s approval.” The purpose was to make sure that DIP didn’t assume “by accident” (or perhaps better, “by ambush”). It hasn’t quite worked that way: there remains the question of contracts that are neither assumed nor rejected before the confirmation of the plan. Do we assume that they are implicitly rejected? Or implicitly assumed? There is no compelling answer to this question.
Prudent counsel sidesteps it by inserting language in the plan of reorganization, as, for example “all executory contracts not explicitly assumed are deemed rejected.”

One notable fact of executory contract law is that courts seem to assume that if something is an executory contract when the debtor is the transferee, then it must be also when the debtor is the transferor. It isn’t obvious that this must be so. But in a much-noticed case, the Fourth Circuit held that a technology licensing agreement was an executory contract when the debtor was the licensor. *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), *cert denied, Lubrizol Enterprises, Inc. v. Canfield*, 475 U.S. 1057 (1986). The decision touched off a rumpus in the intellectual property bar. Consider the case of a non-debtor licensee who had poured a big investment into developing a factory to deploy the intellectual property. It risked losing the value of his investment with nothing but an unsecured claim against the estate, at best.

Responding to the concerns of the industry, Congress adopted present §365(n), designed to secure the rights of the non-debtor licensee as intellectual property (other than trademarks, for some reason), notwithstanding the rejection by the licensor. Congress could, of course, have simply redefined “executory contract,” to specify that it did not cover intellectual property rights where the debtor was the transferor—but it did not. Section 365(n) basically provides that if the debtor-licensor rejects the license, the licensee can elect to retain the license if it continues to pay the royalties that are owed, but it cannot enforce other provisions of the agreement that impose performance obligations on the licensor. Thus, it is far from a perfect solution for intellectual property licenses as its protections are generally linked to preserving the status quo as opposed to securing future benefits to which the licensor would have had a right, such as upgrades and technical support.
APPENDIX 13(a)
IN RE MIDWEST PORTLAND CEMENT COMPANY

46 Bankr. Ct. Dec. 45 (3rd Cir. 2006) (limited citation per 3d Cir. Rules)

At issue is whether a contract entered into by the debtor is executory and therefore one that the bankruptcy trustee may assume and assign under 11 U.S.C. §365. Both the Bankruptcy Court and the District Court held that the contract is not executory.

I.

The relevant facts are undisputed, well-known to the parties, and were set forth in full in the opinions below. We thus summarize for purposes of this appeal. On March 15, 1993, Midwest Portland Cement Company (Midwest), and appellee Maysville Regional Water Department (Maysville), entered into a contract for the sale of real property located in Muskingum County, Ohio. Midwest sold to Maysville: (i) the land surrounding a water source that Maysville owns called Frazier Quarry; and (ii) a separate property called Lake Isabella. Each party also secured an easement in the transaction. Midwest retained an easement through Maysville’s property so that it could construct a conveyor belt and storage facility for limestone that it mined from an adjacent property where Midwest had mining rights. That adjacent property is owned by the appellant in this proceeding, Kent’s Run Partnership Ltd. (Kents Run). Maysville, in turn, obtained an easement to run waterlines from the Lake Isabella property across certain adjacent property that Midwest still owned. The parties recorded a deed on Dec. 22, 1993, reflecting the sale. Maysville made full payment under the contract.

On May 5, 1997, an involuntary petition placed Midwest in Chapter 7 bankruptcy proceedings. In 2002, the Bankruptcy Court approved a settlement agreement among Midwest’s Bankruptcy Trustee (the Trustee), Kents Run, and two other companies that, like Kents Run, were claimants in the bankruptcy proceedings. As relevant here, the settlement agreement called for the Trustee to seek approval from the Bankruptcy Court to assume the 1993 contract with Maysville on the ground that the contract is “executory.” See 11 U.S.C. §365(a) (“The trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.”). If approved, the Trustee would then assign the executory contract to Kents Run.1 Kents Run, it appears, is primarily interested in Midwest’s easement to construct a conveyor belt and storage facility for stones mined from Kents Run’s property. At the time of the bankruptcy petition, Midwest had yet to develop its easement.

The Bankruptcy Court denied the Trustee permission to assume the 1993 contract. It agreed with Maysville that the contract is not “executory” within the meaning of §365 because the parties’ sale of property became final and complete upon recording their deed, and neither Midwest nor Maysville has remaining obligations that would constitute a material breach if

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1 A trustee has authority to assign an executory contract, §365(f)(1), but must first assume the contract, §365(f)(2).
unperformed. The Court also concluded that the easement granted to Midwest is personal and non-assignable. The District Court affirmed. *Kent’s Run P’ship, Ltd. v. Glosser*, 323 B.R. 408 (W.D. Pa. 2005). It too held that the contract is not executory and concluded, alternatively, that Midwest’s easement is non-assignable.

Kents Run filed this appeal. We have jurisdiction under 28 U.S.C. §158(d). See *Matter of Taylor*, 913 F.2d 102, 104 (3d Cir. 1990). The question whether the parties’ contract is executory under §365 is a legal one subject to de novo review. *In re Sunterra Corp.*, 361 F.3d 257, 263 (4th Cir. 2004).

II.

Kents Run contends that as of the date of the bankruptcy petition, there were five unperformed obligations by Midwest and Maysville concerning the two easements conveyed in the 1993 sale. It contends that (1) Midwest must “more particularly describe” its easement after it constructs the conveyor belt and storage facility; (2) Maysville must “more particularly describe” its easement after constructing the waterlines; (3) Midwest must make any conveyance of the property over which the waterlines run subject to Maysville’s easement; (4) Maysville must record an appropriate written document regarding the portion of Midwest’s easement that crosses over Frazier Quarry; and (5) Midwest must file a document in the chain of title to provide subsequent purchasers with notice of Maysville’s easement. According to Kents Run, the District Court erred in failing to deem the 1993 contract executory based on these unperformed obligations. We disagree.

This court has defined an executory contract for purposes of §365 as “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” *Sharon Steel Corp. v. Nat’l Fuel Gas Distrib. Corp.*, 872 F.2d 36, 39 (3d Cir. 1989) (citations omitted); see also *In re Columbia Gas Sys. Inc.*, 50 F.3d 233, 239 (3d Cir. 1995) (“Unless both parties have unperformed obligations that would constitute a material breach if not performed, the contract is not executory under §365.”). “The time for testing whether there are material unperformed obligations on both sides is when the bankruptcy petition is filed.” *In re Columbia Gas*, 50 F.3d at 240.

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2 The Trustee has not appealed the District Court’s judgment, nor was the Trustee required to pursue an appeal under the terms of the approved settlement agreement between the Trustee and Kents Run. App. at 48. Notably, the Trustee and Kents Run did not make the validity and enforceability of their settlement contingent or conditional upon the result of the present proceeding. Id.

3 In the District Court, Kents Run also cited Midwest and Maysville’s obligation to limit use of the easements to the particular purposes for which they were granted. The District Court rejected that ground because “any use of the property interest contrary to the right which was granted is a property dispute, not a breach of the original contract.” *Kent’s Run*, 323 B.R. at 417. Because Kents Run does not pursue this argument on appeal, we do not address it.
The parties agree that the materiality of any unperformed obligation under the 1993 contract must be evaluated under Ohio law. See also id. at 239 n.10. Ohio courts generally look to the Restatement (Second) of Contracts, which presents five factors as significant in determining whether a failure to render or to offer performance is material:

(a) the extent to which the injured party will be deprived of the benefit which he reasonably expected; (b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived; (c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture; (d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking into account all of the circumstances including any reasonable assurances; and (e) the extent to which the behavior of the party failing to perform or to offer to perform comports with the standards of good faith and fair dealing.


Kents Run first contends that Midwest and Maysville have yet to “more particularly describe” their respective easements. As the District Court recognized, however, these unperformed obligations are conditioned under the terms of the parties’ agreement upon the occurrence of events that have yet to occur. “There is a distinction in the law between failure of a condition and breach of a duty: ‘Non-occurrence of a condition is not a breach by a party unless he is under a duty that the condition occur.’” In re Columbia Gas, 50 F.3d at 241 (quoting Restatement (Second) of Contracts §225(3) (1981)).

The terms of the parties’ deed requires a further description of Midwest’s easement after Midwest constructs the conveyor belt and storage facility. Maysville likewise must first construct its waterlines before added description becomes an obligation. It is undisputed that neither Midwest nor Maysville had developed the easements at the time of the bankruptcy petition. Moreover, Maysville and Midwest were under no contractual duty or promise to create the contemplated improvements on the easements. Absent such a duty, failure to perform the contingent obligations of further description did not breach the contract. The same holds true for the claim that the contract is executory due to Midwest’s obligation to burden any future conveyance with the Maysville easement-any breach of this obligation could not occur until Midwest conveys the property without notice of the easement, but Midwest had not conveyed the property, nor was it under an obligation to convey it, prior to the bankruptcy proceeding.

Kents Run concedes that the parties were under no duty to make the conditions precedent occur, see Appellant’s Br. at 29, but it argues that a contract that is dependent upon the occurrence of an event, the happening of which is not the contractual obligation of any party, can still be an executory contract even though the triggering event had not occurred as of the date of the bankruptcy petition. Id. at 27. Kents Run cites, without elaboration, two bankruptcy court decisions holding that a contract for an option to purchase real estate or an unused right of first refusal on a real estate purchase can be executory. Id. (citing In re Kellstrom Indus., 286 B.R. 833 (Bankr. D. Del. 2002); In re Carlisle Homes, Inc., 103 B.R. 524 (Bankr. D.N.J. 1988)). We
find, however, that the law as it applies in the present context is sufficiently clear: “if the remaining obligations in the contract are mere conditions, not duties, then the contract cannot be executory for purposes of §365 because no material breach could occur.” *In re Columbia*, 50 F.3d at 241. For the reasons stated, the first three unperformed obligations cited by Kents Run were properly held to be mere conditions.\(^4\)

Kents Run’s final two claims of material breach are that Maysville failed to record a document regarding the portion of the Midwest easement that crosses over Frazier Quarry, and that Midwest failed to record a document in the chain of title to provide subsequent purchasers with notice of the Maysville easement. The District Court held that the parties’ failure to create and record these documents did not render the contract executory because “these outstanding duties were not material.” *Kent’s Run*, 323 B.R. at 419. The District Court determined that the 1993 deed was effective under Ohio law to create legally enforceable easements between the parties. To the extent that Midwest and Maysville have both lost a benefit under the contract insofar as the easements have yet to be made enforceable against subsequent purchasers, Maysville has expressed its readiness to execute the appropriate documents, the act of creating and filing those documents is ministerial, and there is no indication that either party failed to comply with the standards of good faith and fair dealing. The District Court thus concluded that the unperformed obligations do not amount to a material breach.

Having reviewed the record, we find no error in the District Court’s analysis. Kents Run does not dispute that the parties’ deed was sufficient under Ohio law to create and record the easements as between Midwest and Maysville. Rather, Kents Run takes issue with the District Court’s application of the Restatement (Second) factors, set forth supra, in holding immaterial the failure to record documents needed to enforce the easements against subsequent purchasers. Kents Run argues in particular that the District Court erred in giving weight to Maysville’s representation that it was prepared to record an appropriate document concerning the portion of the Midwest easement that crosses Frazier Quarry, noting that Maysville failed to make that representation prior to the bankruptcy proceeding. As noted, the petition date marks the time to determine materiality of unperformed obligations for purposes of §365, *In re Columbia Gas*, 50 F.3d at 240, but here Maysville had no notice until the bankruptcy proceeding that Midwest believed the contract was breached by failure to record the easement document. Under the circumstances, Maysville’s clear statement of its intention to file the necessary documents, which by all accounts is a ministerial task, was properly weighed against finding a material breach. Moreover, the District Court rightly observed that there was no conduct by either party to the 1993 contract reflecting a lack of good faith or fair dealing.

At bottom, “not every contract that appears executory because it has not been completely performed is executory for purposes of §365.” *In re Columbia Gas*, 50 F.3d at 244 n.20. We

\(^4\) In Judge Brody’s view, the District Court was required to apply Ohio’s five-factor Restatement test to the first three unperformed obligations cited by Kents Run, even though those obligations were contingent obligations. Nonetheless, Judge Brody agrees that a breach of the three unperformed obligations would not constitute a material breach under Ohio law and, therefore, the three obligations do not give rise to an executory contract under section 365.
agree with the Bankruptcy Court and the District Court that the contract here is not executory merely because the parties failed to perform various, non-material obligations with respect to the easements conveyed. As such, assumption of the contract was properly denied under §365. 5

III.

For the reasons stated, we will affirm the District Court’s judgment.

5 Given our conclusion that the contract is not executory and cannot be assumed by the Trustee under §365(a), we need not reach the question whether assignment of the contract would impermissibly expand the nature of the easement granted to Midwest.
Chapter 14
CONFIRMING A PLAN

Chapter 11 plans come in all shapes and sizes.

- There are prepackaged plans, pre-arranged plans, and “regular” plans.
- There are plans of reorganization and plans of liquidation.
- There are consensual plans and non-consensual plans.
- There are plans that effect a particular transaction, like a sale or a merger.
- And there are plans proposed by a debtor, a committee, or another party.

When drafting a plan, it makes sense to start with one or more precedent plans (why reinvent the wheel?). Ideally, the precedent you use will have some things in common with your plan. Remember though, precedent documents were negotiated for a prior case; take the time to “reset” provisions in favor of your client before using an old plan as part of negotiations. It is also very helpful to have an outline or term sheet of some sort that delineates the key business points to be included in the plan. Without this, trying to draft a plan is akin to trying to hit a shadow: a plan merely memorializes the deal. The client (with counsel’s input) needs to decide how it wishes to group creditors and equity owners and how much (and how) it wants to pay them. Our job is to try to effectuate the client’s goals and to advise the client if any of its goals are unlikely to be achievable.

Here is a short lesson on how to confirm a plan under chapter 11.

Turn your bankruptcy code to subchapter II of chapter 11. Change into something comfortable and turn down the lights (no, that’s a different book we are writing).

First, look at §1121, to see whether your client can propose a plan. Part of this will depend on whether the “exclusive period” has expired. DIPs have the exclusive right to propose a plan for the first 120 days of the case (this period can be extended up to 18 months after entry of the order for relief). After exclusivity expires, the door is open to other parties who may want to propose a plan. The rules are slightly different for small business cases. See §1121(e).

Then turn to §1122. This deals with classification of claims and interests. It says you can only classify claims together if they are “substantially similar.” It doesn’t say what “substantially similar” means, and it doesn’t say whether you can classify claims that are “substantially similar” in separate classes—which is often helpful in trying to achieve the required votes. So that’s all left to the case law (of which there’s a lot). Bankruptcy Code §1122 also permits what are referred to as “convenience classes”—something like “all unsecured creditors whose claims are less than $5,000, or who agree to reduce their claims to $5,000, get paid in full.”
The next section, 1123, deals with what can go in a plan. The first part, subsection (a), outlines what a plan must contain. Always use this section as a checklist to make sure you have done everything you are required to do. Subsection (b) lists provisions that a plan may contain and it is very broad. But remember that to be effective a plan must be confirmed under §1129, and that provides a substantial check on §1123’s broad provisions.

Bankruptcy Code §1124 defines what constitutes “impairment” of a class of claims or interests. This is important because “impaired” classes get to vote on the plan. A basic oversimplification is this: if the plan alters the rights you would otherwise have, positively or negatively, you are impaired.

Bankruptcy Code §1125 deals with requirements for a disclosure statement. The Code provides that we cannot solicit acceptances of our plan until we have provided the creditor with a “disclosure statement” sufficient to enable him to cast a rational vote. Think “securities prospectus.” No, try not to think “securities prospectus.” The drafters pretty clearly intended that the disclosure statement be something more informal than a full-fledged S-1. Indeed, §1125(e) provides a “safe harbor” from the registration and solicitation provisions of the securities laws for the proponents of plans providing for the issuance, purchase or sale of securities, if the proponents complied with the requirements of the Bankruptcy Code, including §1125, and solicited acceptances of the plan in good faith.

In order to get to the confirmation hearing, you need to have your disclosure statement approved by the court. Parties are permitted to object to the disclosure statement and the court will conduct a hearing on its adequacy. Often the objections do not really go to disclosure, but are instead disguised (sometimes very thinly disguised) objections to the plan itself. The practical result is that the hearing on the disclosure statement can become kind of a preview of the plan confirmation battle.

Bankruptcy Code §1126 deals with who has accepted and who has rejected a plan. More about that below.

Bankruptcy Code §1127 deals with modification of a plan. The important rules here are (1) you can’t modify a plan so that it fails to comply with the requirements for a confirmable plan, and (2) if you modify a plan in a material way, after creditors have voted, then you are likely to have to re-disclose and re-solicit—that is, tell the creditors about the change and give them a chance to change their vote, if they want to do so.

Bankruptcy Code §1128 says the court will hold a hearing to consider confirmation of the plan, and that parties can object to confirmation if they want to do so. That takes us to the heart of the matter—§1129—the Bankruptcy Code section that sets the criteria for confirmation.

Start with the “general” requirements of §1129—those that apply to the plan itself, as opposed to the acceptance of the plan by, and treatment of, particular classes of creditors. Those general requirements are found in subsections 1129(a)(1) through (a)(6), and (a)(11) through (a)(15). Some of these are specific requirements, such as the requirement that the plan proponent disclose the identity of and compensation to be paid to any insider who will be retained by the
reorganized debtor. Some are more general, such as the requirement that the plan be proposed “in good faith”—a judgment call for the court.

One of these requirements that deserves special note is the “feasibility” test of §1129(a)(11). The proponent must show that the plan is not likely to be followed by a liquidation or further reorganization of the reorganized debtor, unless the liquidation or further reorganization is provided for in the plan.

Then turn to the sections that deal with the treatment of classes of creditors. With respect to each class of creditors and interest holders, the proponent should ask: can I meet the confirmation requirements?

If the answer is “no,” go back to the drawing board. If your answer is “yes” with respect to all classes, then you are pretty much done. With respect to any particular class, how do you get to “yes?” There are three ways.

- **Leave the class “unimpaired.”** If the class is unimpaired, it is deemed to accept the plan and, for most purposes, you don’t have to worry about them any more.

- **Get their votes.** If you get the right number of votes, you can confirm with respect to a class. More important, you can impose the plan on dissenters within a class. Indeed, this rule is the linchpin of Chapter 11—something vital that you can do under the Bankruptcy Code that you cannot do outside bankruptcy. There is only one important catch; we’ll explain it later.

- **Cram them down.** Finally, even if the class is impaired, and even though you don't have the votes, you may still be able to confirm—to impose the plan on the dissenting class over its objection. You do it under the “fair and equitable” rule of §1129(b), more commonly (if less elegantly) known as the “cram-down.”

We consider each of these in turn.

**Leaving the Class Unimpaired**

Section 1129(a)(8)(B) provides that we need not obtain the acceptance of an unimpaired class (and §1126 instructs us that we need not even solicit the votes of creditors in an unimpaired class, as such creditors are conclusively presumed to accept the plan).

**Getting the Votes**

If the claims (or interests) in a class are impaired, then the debtor needs to rely on §1129(a)(8)(A) and solicit votes of the class members. You can confirm with respect to a voting class if you get the votes of:

- a majority in number and

- two-thirds in amount
of those voting (not “of all creditors”). So, if there are 200 creditors in a class and only 10 cast ballots, you have a majority in number if you have six votes. So also, if claims total $1 million and only claims aggregating $100,000 return ballots, then you have two thirds in amount if you get the votes of claims aggregating $66,667. See §1126.

Once you have the votes, you can impose the plan on dissenters in the class. There is only one important exception to this important rule: a dissenting creditor (even one in a consenting class) may defeat confirmation if he can show that he would receive less under the plan than in a chapter 7 liquidation. This is the “best interest” test of Bankruptcy Code §1129(a)(7), sometimes also known as the “liquidation test.” Most courts will insist that you provide a “liquidation analysis” in the disclosure statement, accompanying your plan, to show whether the plan passes the liquidation test.

For example, suppose we have a class of claims aggregating $100,000, who would get $20,000 in a liquidation. We propose to pay them $10,000 next year and $10,000 more the following year. Can we confirm with respect to this class? Probably not. Money now is worth more than money later. If the relevant interest rate is anything greater than zero, then two (deferred) payments of $10,000 do not have a (present) value of $20,000, and the creditor class is getting less than it would get in a chapter 7. Because the plan fails the best interest test, it cannot be confirmed—even by a cramdown.

Cramming Down

Even if a class is impaired, and even if you don’t have the votes, you still may be able to cramdown under §1129(b). It is important to remember that cramdown, although a broad and powerful term, can only overcome one sort of §1129(a) deficiency—the failure of a class to vote to accept the plan under §1129(a)(8). Even in a cramdown confirmation, all the other §1129 requirements must be met.

Suppose the debtor owes $1 million to the creditor under a contract providing for payment in annual installments over 10 years, with interest at 10 percent (the payment pencils out at about $162,000 a year). The debt is secured by Blackacre, which, luckily, is worth $1 million—exactly the same amount as the debt.

The creditor has made it clear that he favors no resolution except payment in full immediately. Your client certainly can’t do that; indeed, he can’t even meet the installments.

But he could pay a lower installment. You fire up the spreadsheet and determine that if you strung the loan out from 10 to 20 years at the same rate of interest, then the payment would fall to around $127,000. Your client figures he could pay $127,000.

Can you impose this deal under the cramdown rule? Let’s say it’s a close call. The rule provides that we can impose the plan if the creditor gets a payment stream with a present value equal to the amount of its secured claim. Indeed, we are proposing to give him a payment stream with a value equal to his claim—if 10 percent is the right interest rate.
The creditor will say that a 20-year loan is riskier than a 10-year loan and so he has a right to a higher interest rate. But if the interest rate is higher than 10 percent, a stream of 20 payments of $127,000 has a present value that is less than $1 million. So we may be heading for a fight over the question of what the right interest rate is.

In *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), the Supreme Court adopted the “formula approach” for determining the appropriate interest rate to be used to determine the present value of a stream of payments. Under this approach, the national prime rate is used as a starting point and is increased based upon the risk of default in the particular case. The Court rejected the “coerced loan,” “presumptive contract rate,” and “cost of funds” approaches for determining an interest rate.

*Till* involved payments to a secured creditor under a chapter 13 plan. The case raises, but does not definitively answer, the question of whether the same approach should be used in chapter 11 wherever the Bankruptcy Code requires a plan to provide a secured, priority or unsecured creditor with payments having “a value, as of the effective date of the plan, equal to” the allowed amount of its claim.

If we change the hypothetical, and the collateral value is less than the amount of the debt, then the plan will treat the claim as two claims—one secured and one unsecured. For example, if the creditor has a debt of $50 million, secured by collateral with a value of $35 million, then, pursuant to §506(a), it has a $35 million secured claim and a $15 million unsecured deficiency claim. Its claim is “bifurcated” into those two parts. Let’s say the $50 million debt carried a 13 percent interest rate and was scheduled to mature six months after the bankruptcy petition was filed. The plan can cram down the secured claim by giving the creditor a stream of payments with a present value of $35 million, just as the creditor in the prior hypothetical was entitled to a stream of payments with a present value of $1 million. As a result, this secured creditor may find himself with a new note that has a smaller principal balance than his original note, an extended maturity, and perhaps a lower interest rate as well.

If the plan proponent seeks to cram down a class of unsecured creditors (or a secured lender’s deficiency claim—as in the example above—since the deficiency claim is treated as an unsecured claim), then no junior class can receive anything on account of its pre-bankruptcy claim unless the plan provides that each holder in the class “receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim.”

This last limit is important: it means that the equity class will ordinarily not support a cramdown plan, unless the plan pays the whole of the cramdown debt—since if it fails to do so, equity (a junior class) cannot receive anything.

There is yet one more limit on cramdown. Remember, §1129(b) can only excuse failure to satisfy §1129(a)(8). Thus, if we propose to impose the plan on a dissenting class of claims, then we must show that at least one impaired class of claims has voted to accept the plan. See §1129(a)(10). You can’t cram down everyone. Think of this as the “somebody has to like it” rule. It is important for a debtor to have at least one class of “friends.”
APPENDIX 14(a)
IN RE TRACEY BARNES, DEBTOR

This edited order illustrates some of the mechanics of cram down confirmation in a small chapter 11 case.


ORDER CONFIRMING PLAN OF REORGANIZATION

This contested confirmation case presents several issues: classification of classes under the Debtor’s plan of reorganization (the “Plan”), valuation of property transferred under the Plan, the “good faith” of the Debtor in filing his Plan, and the feasibility of the Plan. After considering the record made at the confirmation hearing, the court concludes that the Debtor has met his burden of proof, and his Plan will be confirmed.

Events Leading Up to Bankruptcy

Tracey Barnes (the “Debtor”) is in the music business. Specifically, the Debtor owns 88 percent of Asgaard Interactive Multimedia, LLC (“Asgaard”), a company that owns and operates an on-line magazine and an on-line radio station known as Hard Radio which was launched on Dec. 31, 1995, as the first radio station operated exclusively on the internet. Six other stockholders in the company own the remaining 12 percent of the shares of stock.

Bruce and Joe Campbell (the “Campbell Brothers”) were contributors to the Hard Radio Web site. They and the Debtor have been engaged in hotly contested litigation before the United States District Court and the Magistrate Judge presiding over the litigation for several years. In that litigation, the Campbell Brothers sued the Debtor for breach of an alleged agreement by the Debtor to transfer to the Campbell Brothers a 12 percent interest in the company. In May 2003, after a jury trial, the district court entered a judgment (the “Judgment”) against the Debtor for breach of contract and awarded the Campbell Brothers damages in the amount of $675,000, representing 12 percent of the value placed by the jury on Hard Radio as of the time that the transfer of the interest in Asgaard to the Campbell Brothers was supposed to have occurred in 2000. On August 11, 2003, after the Judgment was entered, the Debtor filed a petition for relief under Chapter 11 of the United States Bankruptcy Code.

Since the filing of the bankruptcy case, the Debtor has moved expeditiously through the plan confirmation process. A disclosure statement was filed, noticed, and approved by this Court on Oct. 31, 2003. The Debtor’s Plan, which was filed on Sept. 9, 2003, was sent out to creditors and parties in interest, and votes were solicited by the Debtor. All creditors other than the Campbell Brothers voted in favor of the plan. In addition, the Campbell Brothers were the only creditors to file an objection to the proposed Plan.
Campbell Brothers’ Objections to the Plan

Under the Plan, the Debtor proposes to transfer 6 percent of his interest in Asgaard, which owns Hard Radio, to each of the Campbell Brothers in complete satisfaction of their claims. The Plan places the claims of the Campbell Brothers in Class 4, along with one other claimant. Class 4 is listed as a non-impaired class. The Campbell Brothers object to this treatment under the Plan. They argue that, because they and the other claimant in Class 4 are receiving property, rather than cash, in payment of their claims, Class 4 is an impaired class. They also argue that the value of the stock to be transferred under the Plan is not $675,000. Additionally, the Campbell Brothers assert that the Debtor should have considered other options, including selling shares in Asgaard and paying the Campbell Brothers in full with the proceeds, and that the failure of the Debtor to do so shows that the Debtor did not file the Plan in good faith. Lastly, the Campbell Brothers objected to the Plan on the basis that it is not feasible.

Impairment of Class 4 Under the Plan

As noted above, the class of claims of which the Campbell Brothers’ claims are a part was classified in the Plan as a non-impaired class. The issue is relevant in this case because, under §1126(f) of the Bankruptcy Code, if Class 4 is not impaired, it and the Campbell Brothers would be “conclusively presumed to have accepted the plan,” 11 U.S.C. §1126(f), which would mean that all impaired classes would have accepted the plan pursuant to §1129(a)(8) of the Code. On the other hand, if Class 4 is impaired, then Class 4 would be treated as a rejecting class because the Campbell Brothers, whose claims represent more than two-thirds in amount and more than one-half in number of Class 4 claims, have rejected the Plan. See 11 U.S.C. §1126(c) (“A class of claims has accepted a plan if such plan has been accepted by creditors...that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors...that have accepted or rejected such plan.”). At the hearing on confirmation, the Debtor conceded that Class 4 was a non-accepting impaired class and that he would have to proceed under the “cram down” provisions of §1129(b).

Value for “Cram Down” Purposes

The “cram down” provisions allow a debtor to confirm a plan over the objections of a non-accepting impaired class if, with respect to a class of unsecured claims,

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

11 U.S.C. §1129(b)(2)(B). The Debtor and the Campbell Brothers disagree about whether the interest in the Asgaard stock that is proposed to be transferred to the Campbell Brothers under the Plan has a value of at least $675,000 so as to satisfy the requirements of §1129(b)(2)(B)(i).
Although the terms of the Plan indicate that the interests to be transferred to the Campbell Brothers total 12 percent of the Debtor’s interest in Asgaard (which is 88 percent of the total shares of stock), the Debtor’s arguments at the confirmation hearing and his testimony in support of the value of the shares to be transferred to the Campbell Brothers under the Plan indicated that the interest proposed to be transferred in satisfaction of the Campbell Brothers’ claims is 12 percent of the total outstanding shares of Asgaard, not 12 percent of the Debtor’s interest in Asgaard.

The Debtor submits that the value of 12 percent of the Asgaard stock would be worth at least $675,000 as of the effective date of the Plan because (1) the amount of the judgment entered in the district court litigation, which forms the basis of the Campbell Brothers’ claims, was arrived at by a jury finding that 12 percent of Hard Radio was worth $675,000 in 2000, and (2) the value of Hard Radio has only increased since that time. The uncontroverted testimony of the Debtor was that the value of on-line radio stations on the open market is based on the number of customer “hits” on the Web site on a monthly basis and that Hard Radio has substantially more hits per month now than it did in 2000. The Debtor further testified that the fact that the Web site now has a significantly greater number of pages for Web site users to view compared with the number of pages available in 2000 is a further indication of an increase in value of the Hard Radio from 2000 until today. The Campbell Brothers did not put on any evidence regarding the value of the Asgaard stock nor did the Campbell Brothers submit any evidence to controvert the testimony of the Debtor regarding the value of the stock. The Court finds that the value of a 12 percent interest in Asgaard is at least equal to the allowed amount of the Campbell Brothers’ claims as required by §1129(b)(2)(B)(i). Therefore, these requirements for “cram down” have been met by the Debtor.

**Good Faith**

The Campbell Brothers argue that the Debtor’s Plan cannot be confirmed because the Debtor did not file the Plan in good faith. Section 1129 of the Bankruptcy Code requires that, to be confirmable, a plan must, among other things, have been “proposed in good faith and not by any means forbidden by law.” 11 U.S.C. §1129(a)(3). If no objection is filed, the court may determine that the plan has been proposed in good faith without receiving evidence on that issue. See Fed. R. Bankr. P. 3020(b)(2). However, if good faith is contested, then the Debtor has the burden of proof on that issue, and the standard of proof is the preponderance of the evidence.

Good faith in the Chapter 11 plan process is not defined by the Code. Generally speaking, to be proposed in good faith, a plan must “fairly achieve a result consistent with the [Bankruptcy] Code.” In re Block Shim Dev. Company-Irving, 939 F.2d 289, 292 (5th Cir. 1991) (citing In re Madison Hotel Assocs., 749 F.2d 410, 425 (7th Cir. 1984)). Keeping in mind the “fresh start” policy of the Bankruptcy Code, the court must look to the totality of the circumstances surrounding the establishment of the plan to determine whether a plan is filed in good faith. A plan need not be one that the creditors would themselves design to satisfy the requirement of good faith.

In the present case the Debtor has divided the class of unsecured creditors into two classes under the plan. Class 3 consists of those unsecured creditors holding claims in an amount
less than $1,500.00. Creditors in Class 3 will be paid, out of the Debtor’s household income, 50 percent of their allowed claim over a period of 12 months. See P 5.4 of the Plan. Creditors holding unsecured claims of more than $1,500 (which includes the Campbell Brothers and one other claimant) are to receive stock in Asgaard from the Debtor of a value equal to the amount of their Allowed Claim. See P 5.5 of the Plan. Again, although the proposed distribution to the Campbell Brothers is 6 percent of the Debtor’s interest in Asgaard, the Court considers this provision of the Plan to have been modified, by the position taken by the Debtor at the confirmation hearing, to provide for a transfer of 12 percent of the total outstanding shares of stock in Asgaard to the Campbell Brothers. The Campbell Brothers argue that the Debtor did not propose his Plan in good faith because he should have proposed a Plan that would have marketed and sold some of the Debtor’s shares in Asgaard and used the proceeds from the sale to pay the Campbell Brothers’ claims in cash. They also argue that forcing them to be “business partners” (through a minority ownership of stock) in Asgaard with the Debtor will lead to a liquidation of the company and therefore constitutes a lack of good faith on behalf of the Debtor in proposing the Plan.

Although the Campbell Brothers did not specifically raise the issue of the separate classification and disparate treatment of their claims from the claims of unsecured creditors holding claims in amounts less than $1,500, the Court notes that this separate classification and treatment is allowed under the Code if done for administrative convenience and would not, therefore, be a basis for a finding that the Debtor has proposed his Plan in bad faith. See 11 U.S.C. §1122(b) (which allows a plan proponent to “designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.”).

Turning to the Campbell Brothers’ specific arguments regarding the Debtor’s lack of good faith in filing his Plan, the Court notes again that the fact that a plan proposed by a debtor is not the one that the creditors would have proposed does not make the plan one that has not been filed in good faith. Instead, this Court must look to all of the circumstances surrounding the filing of the Plan to determine if the Plan was proposed in good faith.

Here, the Debtor testified that he did not have funds nor did he anticipate having funds in the near future that would be sufficient to pay the claims of the Campbell Brothers of any substantial part of those claims. Instead, the only asset of value that he has to satisfy the claims of the Campbell Brothers is the stock in Asgaard. The Debtor testified that his goal is to continue to increase advertising time on Hard Radio, which would increase the value of Asgaard. He will eventually sell Asgaard, at which time the holders of the stock in Asgaard, including the Campbell Brothers, will be paid for their stock. The Debtor is motivated to maximize the value of the holding company because he will continue to own a substantial interest in the holding company. Debtor has great incentive and risk in the future of the holding company. Although few creditors voted in this case, all creditors except the Campbell Brothers voted to accept the plan.

The Court notes that the Debtor’s Plan that proposes to satisfy creditors’ claims by giving to them property valued in the plan process, is not new. This type of treatment of an unsecured creditor class is specifically authorized under §1129(b)(2)(B)(i), and, assuming the value of the
property transferred is “equal to the allowed amount of such claim,” such treatment would satisfy the requirement that the plan be “fair and equitable” for cram down purposes. 11 U.S.C. §1129(b)(2)(B)(i); see also Collier on Bankruptcy P 1129.05[3] (“Under §1129(b)(2)(B)(i), the proponent must satisfy the claim in full, but is allowed to use non-cash assets, such as stock or notes or a combination of them as the medium of payment.”). Thus, treatment of a class of claims in a manner specifically authorized by the Bankruptcy Code cannot constitute evidence that a plan was not proposed in good faith. Because the Campbell Brothers did not submit any evidence in support of their contention that the Plan was not filed in good faith, the Court finds that the Debtor’s Plan was proposed in good faith.

**Feasibility of the Plan**

The Campbell Brothers argue that the Debtor’s Plan is not feasible because (1) the value on the stock to be distributed under the plan is not accurate and (2) the proposed transfer of stock in Asgaard in satisfaction of their claims will force them to be “joined at the hip” with the Debtor and ultimately lead to a liquidation. The Court has already addressed the issue of the value of the stock to be issued under the Plan. Having found that the evidence submitted at the confirmation hearing supports a valuation of at least $675,000 (the combined amount of the Campbell Brothers’ claims) for the 12 percent of the outstanding shares in Asgaard proposed to be transferred in satisfaction of the Campbell Brothers’ claims, the Court rejects the Campbell Brothers’ argument that the valuation somehow causes the Debtor’s Plan to be not feasible.

The Court also rejects the Campbell Brothers’ remaining contention that their ownership of stock in Asgaard will force them to be business partners with the Debtor, and, presumably because of the volatile nature of their relationship, cause a liquidation of Asgaard. The feasibility requirement in connection with a Chapter 11 plan of reorganization is found in §1129(a)(11) which requires that the confirmation of the plan “is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.” 11 U.S.C. §129(a)(11). It is the debtor’s burden to prove the feasibility of a Chapter 11 plan by the preponderance of the evidence.

In this case the Debtor testified, without any controverting testimony or evidence from the Campbell Brothers, that the value of the shares to be transferred under the Plan to the Campbell Brothers is higher than the value, as of 2000, placed on those shares by the jury in the district court litigation. The Debtor also testified that the value will continue to grow and that it is his plan to sell Asgaard when the value of Hard Radio is maximized after further development of the Web site. Because the Debtor’s testimony regarding the continued growth in the value of the Asgaard stock was both credible and uncontroverted and because the Debtor appears to have a sound business plan regarding Hard Radio, the Court finds that it is not likely that this Debtor’s plan will be followed by a liquidation or further reorganization of this Debtor. The fact that the Debtor, as a majority shareholder in the holding company of Hard Radio, plans the future liquidation of that asset does not make his Plan not feasible. In fact, the liquidation of Asgaard would give them what they are asking for: cash for their claims so that they can walk away from this Debtor and his company. That they may have to wait some period of time before this may occur puts them in a position that is no different from many other unsecured creditors’ positions.
in most Chapter 11 reorganization cases. Therefore, the Court finds that the Debtor’s Plan is feasible under §1129(a)(11).

For the foregoing reasons, the Court will confirm the plan of reorganization submitted by the Debtor over the objections of the Campbell Brothers on the condition that the confirmation order provide that the distribution of the Asgaard stock to the Class 4 claimants, including the Campbell Brothers, be in the indicated percentages of the total outstanding shares of Asgaard, rather than percentages “of Asgaard stock owned by Debtor.” Accordingly,

IT IS ORDERED that the Debtor’s plan of reorganization filed on Sept. 9, 2003, be, and hereby is, confirmed on the condition stated herein.
CHAPTER 15
SMALL BUSINESS PROVISIONS

One of the things about chapter 11 that presents itself in many contexts in practice is the fact that it is a “one size fits all” statute: for the most part, the same exact Bankruptcy Code sections, Rules, and case law applies to Betty & Veronica’s Bake Shop as to J.P. Dithers & Company. This comes up all the time: for example, a motion to extend a deadline, like exclusivity, is common in large cases and is often granted, since the time limits that the Code provides as defaults often cannot accommodate the realities of the large case. There are, however, some Bankruptcy Code sections that address the particular needs of smaller cases.

These provisions impose deadlines and reporting requirements that may be burdensome. However, they also contain provisions that may make it easier and more cost effective for smaller companies to obtain the benefits of chapter 11, in part by expediting the plan confirmation process and by instilling some rigor and discipline to prevent the case from losing momentum and bogging down in the swamp that chapter 11 can become.

BAPCPA added or amended many sections dealing with small business debtors. These include: §§101(51)(C) and (D); 308; 1116; 1125(f); 1121(d) and (e); 1129(e); and 362(n).

“Small Business” Debtors Defined

A small business debtor is a person engaged in commercial or business activities other than owning or operating real estate. See §101(51)(D). It may not have more than $2 million in debt, excluding debt to insiders or affiliates. For the DIP to be a “small business debtor,” the UST must not have appointed a creditors’ committee or, if a committee has been appointed, it is necessary that the committee not be “sufficiently active and representative to provide effective oversight of the debtor.” FRBP 1020(c). So, a case could be filed with the DIP otherwise meeting the definition of a small business debtor, but the DIP could then fail to qualify for that status when a committee is appointed, and perhaps, could regain the status of a small business debtor if the committee becomes insufficiently active. This potentially shifting status may be a source of confusion and litigation, with its attendant costs.

Initial Interview

The UST has an obligation to conduct initial interviews with small business debtors prior to the §341 meeting of creditors. The interview is intended to allow the UST to evaluate the DIP’s viability and to agree upon scheduling in the case. The UST is also given an opportunity at this meeting to advise the debtor of its reporting and filing obligations, which if not met, will result in a motion by the UST for conversion or dismissal.

1 We have attached a copy of the Rule as Appendix 15(a).
Duties in Small Business Cases

Section 1116 sets out a list of duties for the trustee or DIP in small business cases:

1. the DIP must append to the voluntary petition (or, in an involuntary case, filed not later than seven days after the date of the order for relief):
   - (A) its most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return; or
   - (B) a statement made under penalty of perjury that no balance sheet, statement of operations, or cash-flow statement has been prepared and no Federal tax return has been filed;

2. senior management personnel and counsel must attend meetings scheduled by the Court or the U.S. Trustee, including initial interviews, scheduling conferences, and meetings of creditors convened under §341, subject to waiver of this requirement by the court upon a finding of extraordinary and compelling circumstances;

3. the DIP must timely file all schedules and statements of financial affairs, subject to possible 30-day extension or longer if the court finds extraordinary and compelling circumstances;

4. the DIP must file all post-petition financial and other reports required by the FRBP or local rules;

5. maintain insurance customary and appropriate to the industry, subject to §363(c)(2);

6. timely file tax returns and other required government filings and timely pay all taxes entitled to administrative expense priority except those being contested by appropriate proceedings; and

7. allow the UST, or a designated representative of the UST, to inspect the debtor’s business premises, books, and records at reasonable times, after reasonable prior written notice.

The unexcused failure to meet the reporting requirements of §1116 is grounds for conversion or dismissal of the case. See §1112(b)(4)(F). It appears that if a DIP misses a reporting deadline and cannot prove a “reasonable justification” for such error, §1112(b)(2)(B)(i), requires dismissal or conversion upon motion of any party in interest.

Exclusivity, Disclosure, and Confirmation

In small business cases, the court may determine that the plan contains sufficient information, and, in that event, no disclosure statement is required. See §1125(f)(1). Disclosure
statements can also be submitted on standard forms. See §1125(f)(2). Conditional approval is allowed with final approval to be given at the confirmation hearing. See §1125(f)(3)(A). The hearing on approval of the disclosure statement can be combined with the confirmation hearing itself. See §1125(f)(3)(C). These innovations for small business debtors may allow more cost efficient reorganizations.

The period within which the DIP has the exclusive right to file a plan is cut off at 180 days after the order for relief. See §1121(e)(1). A plan and disclosure statement must be filed no later than 300 days after the order for relief. See §1121(e)(2). Both of these deadlines may be extended but only upon a showing “by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time.” See §1121(e)(3)(A).

In a small business case, the bankruptcy court is to confirm a plan not later than 45 days after the plan is filed if the plan complies with the applicable provisions of the Bankruptcy Code. Like the deadlines for the exclusivity period and the time for filing plans, this time for confirmation of a filed plan can only be extended upon a showing by the debtor that confirmation of a plan is likely to result within a reasonable time period. See §1129(e); see also §1121(e)(3).

The basic approach of the small business provisions is to expedite the process of plan proposal and confirmation. This is a step toward improving efficiency and controlling costs, as is the Bankruptcy Code’s express recognition of the use of standard forms, which implicitly recognize that simple “pot plan” or “earn out” reorganizations for small businesses can (and should) be a commodity practice, like chapter 7 and 13.

However, other provisions are less obviously beneficial. For example, the definition of “small business” is confusing at best. Further, the reporting requirements and supervisory role of the UST will only be effective tools if embraced by debtors and their counsel; the UST in most districts is ill-equipped to analyze or scrutinize the reports that the statute requires, particularly if there is a high volume of filings.

It will be interesting to see what the effect of the small business provisions will be. They are likely to be a step in the right direction, but chapter 11 remains a forum that is inherently unfriendly to small businesses due to the high fixed cost of the process, which does not decrease in direct proportion to the size of the business.
APPENDIX 15(a)
INTERIM RULES AND OFFICIAL FORMS IMPLEMENTING
THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER
PROTECTION ACT OF 2005 RULE 1020

(a) SMALL BUSINESS DEBTOR DESIGNATION. In a voluntary chapter 11 case, the
debtor shall state in the petition whether the debtor is a small business debtor. In an involuntary
chapter 11 case, the debtor shall file within 15 days after entry of the order for relief a statement
as to whether the debtor is a small business debtor. Except as provided in subdivision (c), the
status of the case with respect to whether it is a small business case shall be in accordance with
the debtor’s statement under this subdivision, unless and until the court enters an order finding
that the debtor’s statement is incorrect.

(b) OBJECTING TO DESIGNATION. Except as provided in subdivision (c), the United
States trustee or a party in interest may file an objection to the debtor’s statement under
subdivision (a) not later than 30 days after the conclusion of the meeting of creditors held under
§341(a) of the Code, or within 30 days after any amendment to the
statement, whichever is later.

(c) APPOINTMENT OF COMMITTEE OF UNSECURED CREDITORS. If the United
States trustee has appointed a committee of unsecured creditors under §1102(a)(1), the case shall
proceed as a small business case only if, and from the time when, the court enters an order
determining that the committee has not been sufficiently active and representative to provide
effective oversight of the debtor and that the debtor satisfies all the other requirements for being
a small business. A request for a determination under this subdivision may be filed by the United
States trustee or a party in interest only within a reasonable time after the failure of the
committee to be sufficiently active and representative. The debtor may file a request for a
determination at any time as to whether the committee has been sufficiently active and
representative.

(d) PROCEDURE FOR OBJECTION OR DETERMINATION. Any objection or request
for a determination under this rule shall be governed by Rule 9014 and served on the debtor, the
debtor’s attorney, the United States trustee, the trustee, any committee appointed under §1102 or
its authorized agent, or, if no committee of unsecured creditors has been appointed under §1102,
on the creditors included on the list filed under Rule 1007(d), and on such other entities as the
court may direct.
Some believe that bankruptcy courts are fast becoming the forum of choice for sales of businesses, troubled or not. Whether this was part of the intent behind the enactment of chapter 11, the practice is here to stay. In fact, some courts have adopted guidelines to supplement the Bankruptcy Code and Rules, on how such sales must be conducted. We have attached a sample set of guidelines as Appendix 16(b).

The bankruptcy sale process under §363 may provide benefits that range from res judicata findings that the sale is not a fraudulent conveyance or otherwise improper or subject to later avoidance; that directors and officers of the debtor have acted in good faith and in an exercise of their reasonable business judgment, consistent with their fiduciary duties; and that the purchaser shall not be liable as a successor of the debtor under nonbankruptcy law. These benefits, coupled with a 10-day appeal period and both statutory mootness under §363(m) and equitable mootness under case law, make a sale appeal difficult to prosecute successfully. Taken together, it is not hard to see why some view chapter 11 as the ultimate mergers and acquisition statute.

The Bankruptcy Code provides two separate and distinct sets of provisions under which a bankruptcy debtor or trustee may sell property free and clear of claims or interests: (1) pursuant to a plan or (2) in a non-plan sale. First, §§1123(a)(5)(D) and 1141(c) govern sales made as part of a plan of reorganization confirmed after an extensive disclosure and hearing process as described in chapter 14. Second, §§363(b) and 363(f) govern sales made prior to plan approval and impose only the Bankruptcy Code’s minimal requirements for notice and a hearing.

In comparison to the plan confirmation process, the nonplan §363(b) sale procedures require much less in the way of notice, disclosure, or opportunities for objectors and alternate bidders to actually be heard. That, coupled with the apparent willingness of courts to make many findings that are beneficial to the seller, the buyer, the insiders and the professionals in the case, provide a speedy, effective way to accomplish a sale.

Bankruptcy Code §363(b) allows sales of property of the estate out of the ordinary course of business, and §363(f) permits a trustee or DIP to sell property of the estate “free and clear” of liens or other interests in the property, if any one of five conditions is met:

1. Applicable nonbankruptcy law permits sale of such property free and clear of such interest;
2. Such entity consents;
3. Such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
4. Such interest is in bona fide dispute; or
Such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Thus, §363 can be used to authorize a pre-plan sale free and clear of interests through a motion to sell. Absent an objection, and assuming that the pleadings provide an evidentiary basis to support the sale, there is not even a need for a hearing, although a hearing typically is held.

The term “interest”—the group of rights that an asset may be sold free and clear of—is not defined in the Bankruptcy Code. Further, courts have largely ignored the absence of the word “claims” in §363(f) and, despite the absence of the word, somewhat routinely approve pre-plan sales free and clear of claims as being within the power to sell free and clear of interests.

A chapter 11 debtor whose goal is a sale free and clear will generally proceed straight to a pre-plan sale before (if ever) engaging in the costly and time consuming process of proposing, confirming, and consummating a plan of reorganization. In fact, it is not uncommon for reorganization cases that began with a plan as the goal to end with a pre-plan sale after things bog down in the middle of the case. The plan process can consume too much time, generate too much expense, or fail to result in a feasible exit strategy for the debtor.

Further, under §363(m), an appeal of a sale order will likely be rendered moot if the sale has been consummated, assuming that requisite findings of good faith were made and no stay of the order is granted prior to the closing. Obtaining a stay generally requires posting a bond which can prohibitively expensive. Bankruptcy Code §363(m) provides:

> Bankruptcy Code §363(m) provides:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section [which are implicated in any 363(f) sale] of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

Bankruptcy Code §363(m) creates a race to close a transaction as soon after entry of the sale order as possible to prevent any stay from issuing and to moot potential appeals. Rule 6004(g) stays sale orders automatically for 10 days—which gives an objecting party time to seek a further stay while it appeals—but courts may, and often do, waive the 10-day stay in their sale approval order.

**Findings of Fact and Conclusions of Law in §363 Sale Orders**

Bankruptcy courts commonly enter extensive findings of fact and conclusions of law supporting §363(f) sale orders. These typically contain detailed provisions insulating the seller, the purchaser, their insiders and professionals from liability. In practice, these findings of fact and conclusions of law are drafted by the debtor’s and the purchaser’s counsel, which may include comments from others, such as the unsecured creditors committee. Despite the somewhat shaky foundation, the practice is widespread and generally accepted. The authority to make such
findings is thought to reside in §§363(b) and (f) or to emanate from §105(a), the “all writs” provision of the Bankruptcy Code.

Some less accommodating courts have recently examined the self-serving excesses of these kinds of sale-comfort orders and have found many of their provisions to be not only improper but also unenforceable and not entitled to preclusive effect in later proceedings if they were not expressly determined in the sale motion proceeding. See, e.g., In re Automationsolutions Int’l, LLC, 274 B.R. 527 (Bankr. N.D. Cal. 2002). The probable result of cases like Automationsolutions is the development of a new comfort provision in the sale order: a finding of fact that all findings and provisions of the order address matters that were necessarily determined in the sale. In any event, the practice of including these broad, insulating provisions in the sale order is likely to continue.

Although §363(f) has been used to bar tort claims that arise post-sale from a product manufactured pre-sale or pre-petition, this practice is somewhat questionable. The most recent decisions seem to foreclose application of §363(f) to so called “future” tort claims by limiting the claims that can be barred on due process grounds.

Conclusion

The old bias in favor of reorganization by plan and against pre-plan sales of substantial portions of a debtor’s assets has eroded over the years. This has led to the frequent use of chapter 11 for pre-negotiated sales of business assets. The §363 sale is quicker and cheaper than a plan. It also does not require a vote by creditors, and it may protect the buyer from, among other things, fraudulent conveyance risk, successor liability, and the debtor’s insiders from breach of fiduciary duty and other claims.

Some counsel routinely advise purchasers of distressed businesses that the preferred method of acquisition is through a quick chapter 11 case featuring a pre-negotiated asset purchase agreement and a pre-plan sale free and clear under §363(f). Indeed, the best practice may be at least to advise clients of the potential benefits of this strategy. In a sense, the Bankruptcy Code is being used to resolve the problem that purchasers often have, in that they are unable to take comfort from the representations, warranties, covenants, and indemnities of the seller of a business, whether failing or not. A free-and-clear sale order with protections for all parties involved that is final and non-appealable, supported by the Bankruptcy and Supremacy Clauses of the United States Constitution, and entitled to full faith and credit in federal and state courts across the country is an effective tool that eliminates the need for the parties to negotiate a transactional mechanism to allocate risk between them.
APPENDIX 16(a)
IN re FLYI, INC.

This edited order is a fairly typical form of sale order entered in the chapter 11 case of Independence Air.


ORDER APPROVING THE SALE OF THE WASHINGTON DULLES AIRPORT USE AGREEMENT AND PREMISES LEASE AND RELATED EQUIPMENT TO UNITED AIR LINES, INC.

This matter coming before the Court on the motion (D.I. 314) (the “Sale Motion”) of the above-captioned debtors (collectively, the “Debtors”) for the entry of an order pursuant to §§105(a), 363 and 365 of title 11, United States Code (the “Bankruptcy Code”) and Rules 2002, 6004 and 6006 of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”) approving, among other things, the sale of the Debtors’ assets, or a portion thereof, free and clear of Liens (as defined below) and the assumption and assignment of contracts and leases in connection therewith, and the Supplement to the Sale Motion (D.I. 546) filed with the Court on Jan. 25, 2006 (the “Supplement”); the Court having reviewed the Sale Motion and the Supplement, and having heard the statements of counsel and evidence adduced with respect to the Sale Motion and the Supplement at a hearing before the Court (the “Hearing”); and after due deliberation the Court having determined that good and sufficient cause having been shown;

THE COURT HEREBY FINDS AND DETERMINES THAT:

1. The findings and conclusions set forth herein constitute the Court’s findings of fact and conclusions of law pursuant to Rule 7052 of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”), made applicable to this proceeding pursuant to Bankruptcy Rule 9014.

2. To the extent any of the following findings of fact constitute conclusions of law, they are adopted as such. To the extent any of the following conclusions of law constitute findings of fact, they are adopted as such.

3. The Court has jurisdiction over the Sale Motion, the Supplement, the sale of the Debtors’ assets, and the assumption and assignment of the Debtors’ executory contracts and unexpired leases pursuant to 28 U.S.C. §§157 and 1334, and this matter is a core proceeding pursuant to 28 U.S.C. §157(b)(2)(A) and (N). Venue of these cases and the Sale Motion in this district is proper under 28 U.S.C. §§1408 and 1409.

4. The statutory predicates for the relief sought in the Sale Motion and the Supplement are §§105(a), 363 and 365 of title 11 of the United States Code (the “Bankruptcy Code”), as supplemented by Bankruptcy Rules 2002, 6004 and 6006.

5. As evidenced by the affidavits of service filed with the Court, (i) proper, timely, adequate and sufficient notice of the Sale Motion, the Supplement and the Hearing has been
provided in accordance with Bankruptcy Rules 2002(a), 6004(a) and 6006, (ii) such notice was
good and sufficient, and appropriate under the particular circumstances, and reasonably
calculated to reach and apprise all holders of Liens and (iii) no other or further notice of the Sale
Motion, the Supplement and the Hearing is or shall be required.

6. Approval of the sale (the “Sale”) of the Airport Assets to United Air Lines, Inc.
(the “Purchaser”) is in the best interests of the Debtors, their creditors, their estates, and other
parties in interest.

7. The Debtors have demonstrated a good, sufficient, and sound business purpose
and justification for the Sale.

8. The Sale was negotiated, proposed and entered into by the Debtors and the
Purchaser without collusion, in good faith, and from arm’s-length bargaining positions and the
Purchaser is entitled to the protections of §363(m) of the Bankruptcy Code.

9. The consideration provided by the Purchaser in connection with the Sale is fair
and reasonable.

10. The Debtors may sell the Airport Assets free and clear of all Liens of any kind or
nature whatsoever because, in each case, one or more of the standards set forth in §363(f)(1)–
(5) of the Bankruptcy Code has been satisfied.

11. The Debtors have demonstrated that it is an exercise of their sound business
judgment to assume and assign the Airport Lease to the Purchaser in connection with the
consummation of the Sale, and the assumption and assignment of the Airport Lease is in the best
interests of the Debtors, their estates, and their creditors.

12. The Debtors have satisfied the requirements of §§365(b)(1) and 365(f) of the
Bankruptcy Code with respect to the Airport Lease.

NOW THEREFORE, THE COURT HEREBY ORDERS, ADJUDGES, AND DECREES
AS FOLLOWS:

General Provisions

1. The Sale Motion is granted with respect to the Airport Assets, as further described
herein.

2. All objections to the Sale Motion with respect to the Airport Assets or the relief
requested therein that have not been withdrawn, waived, or settled, and are overruled on the
merits.

Approval of the Sale

3. The Sale, and all of the terms and conditions thereof, is hereby approved.
4. Pursuant to 11 U.S.C. §363(b), the Debtors are authorized to perform their obligations under and comply with the terms of the purchase agreement (the “Purchase Agreement”) relating to the Sale, and consummate the Sale, pursuant to and in accordance with the terms and conditions of the Purchase Agreement.

5. The Debtors are authorized to execute and deliver, and empowered to perform under the Purchase Agreement, consummate and implement the Sale, and execute and deliver, and perform under, any additional instruments and documents that the Debtors or Purchaser deem necessary or appropriate to implement the Sale, and to take all further actions as may be necessary or appropriate to the performance of the obligations as contemplated by thereby.

Transfer of Assets

6. Except for the Assumed Obligations, pursuant to sections 105(a) and 363(f) of the Bankruptcy Code, the sale of the Airport Assets to the Purchaser shall be, free and clear of all liens, claims, encumbrances, security interests, mortgages and other interests, in each case, whether secured or unsecured, recorded or unrecorded, and whether arising before or after the Commencement Date (collectively, the “Liens”), of any kind or nature whatsoever that do not constitute Assumed Obligations.

Assumption and Assignment of the Airport Lease

7. The assumption of the Airport Lease by the Debtors and the assignment of the Airport Lease to the Purchaser is approved.

8. Except with respect to net Cure Costs in the amount of $452,987.43, the Debtors are not required to make any payment pursuant to §365(b)(1) in connection with the assumption and assignment of the Airport Lease.

9. All non-debtor parties, including MWAA, are barred and precluded from asserting against United any defaults, breaches or claims of pecuniary losses under the Airport Lease existing as of the Closing or by reason of the Closing.

10. Pursuant to §365(k) of the Bankruptcy Code, the Debtors shall be relieved from any liability for any breach of the Airport Lease occurring after Closing.

Additional Provisions

11. The consideration provided by the Purchaser for the Airport Assets is fair and reasonable.

12. This Order (a) shall be effective as a determination that, except for the Assumed Obligations, at Closing, all Liens of any kind or nature whatsoever secured by the Airport Assets prior to the Closing have been unconditionally released, discharged and terminated, and such Liens shall attach to the proceeds of the Sale, and that the conveysances described herein have been effected, and (b) shall be binding upon and shall govern the acts of all entities including without limitation, all filing agents, filing officers, title agents, title companies, recorders of
mortgages, recorders of deeds, registrars of deeds, administrative agencies, governmental departments, secretaries of state, federal, state, and local officials, and all other persons and entities who may be required by operation of law, the duties of their office, contract or otherwise, to accept, file, register or otherwise record or release any documents or instruments, or who may be required to report or insure any title or state of title in or to any of the Airport Assets.

13. Each and every federal, state, and local governmental agency or department is hereby authorized to accept any and all documents and instruments necessary and appropriate to consummate the transactions contemplated by the Sale.

14. This Court retains jurisdiction to enforce and implement the terms and provisions of this Order, the Purchase Agreement, all amendments thereto, any waivers and consents thereunder executed in connection therewith in all respects.

15. The terms and provisions of the Purchase Agreement and this Order shall be binding in all respects upon, and shall inure to the benefit of, the Debtors, their estates, and their creditors, the Purchaser and its respective affiliates, successors, and assigns, and any affected third parties including, but not limited to, all persons asserting a Lien in the Airport Assets, notwithstanding any subsequent appointment of any trustee(s) under any chapter of the Bankruptcy Code, as to which trustee(s) such terms and provisions likewise shall be binding.

16. The failure specifically to include any particular provisions of the Purchase Agreement in this Order shall not diminish or impair the effectiveness of such provision.

17. The Purchase Agreement and any related documents or other instruments may be modified, amended or supplemented by the parties thereto and in accordance with the terms thereof, without further order of the Court, provided that any such modification, amendment, or supplement does not have a material adverse effect on the Debtors’ estates.

18. The provisions of this Order are non-severable and mutually dependent and, pursuant to Bankruptcy Rules 6004(h) and 6006(d), this Order shall not be stayed for 10 days and shall be effective immediately upon entry.
APPENDIX 16(b)
GUIDELINES FOR THE CONDUCT OF ASSET SALES

The United States Bankruptcy Court for the Southern District of New York (the “Court”) has established the following guidelines (the “Guidelines”) for the conduct of asset sales under §363(b) of 11 U.S.C. §§101 et seq. (the “Bankruptcy Code”). The Guidelines are designed to help practitioners identify issues that typically are of concern to parties and the Court, so that, among other things, determinations can be made, if necessary, on an expedited basis.

By offering the Guidelines, this Court does not address the circumstances under which an asset sale or asset sale process is appropriate or express a preference for asset sales under §363(b) of the Bankruptcy Code as opposed to those conducted in the context of confirming a chapter 11 plan, address other substantive legal issues, or establish any substantive rules. However, the Guidelines do require disclosure of the “Extraordinary Provisions,” discussed below, pertaining to the conduct of asset sales, which ordinarily will not be approved without substantial cause shown for such Extraordinary Provisions, or compelling circumstances, and reasonable notice.

The Guidelines are intended to supplement the requirements of §§363(b) and 365 of the Bankruptcy Code, Rules 2002 and 6004 of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”), and Rules 6004-1 and 6005-1 of the Court’s Local Rules.

I. MOTIONS

A. Motion Content.

When an auction is contemplated, the debtor should file a single motion seeking the entry of two orders to be considered at two separate hearings. The first order (the “Sale Procedures Order”) will approve procedures for the sale process, including any protections for an initial bidder, or stalking horse buyer, and the second order (the “Sale Order”) will approve the sale to the successful bidder at the auction. If no auction procedures or stalking horse buyer protection provisions are contemplated, only one order (the Sale Order) and one hearing is required. If no auction is contemplated or the debtor has not actively solicited or will not actively solicit higher and better offers, the motion seeking approval of the sale should explain why the debtor proposes to structure the sale in such manner.

(1) The proposed purchase agreement, or a form of proposed agreement acceptable to the debtor if the debtor has not yet entered into an agreement with a proposed buyer, should be attached to the motion.

(2) The motion also should include a copy of the proposed order(s), particularly if the order(s) include any Extraordinary Provisions.

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1 The term “debtor” includes “debtor in possession” and “trustee,” as appropriate under the particular circumstances.

2 With the exception of providing for such disclosure, these Guidelines do not express a preference for public over private sales as a means to maximize the sale price.
(3) The motion must comply in form with the Local Rules.

(4) If a hearing is required under §363(b) of the Bankruptcy Code in connection with the sale of personally identifiable information subject to a privacy policy of the debtor, the motion should request appointment of a consumer privacy ombudsman under §332 of the Bankruptcy Code.

B. Bidding Procedures.

Generally, the Court will entertain a motion for approval, in a Sale Procedures Order, of proposed bidding procedures if such procedures are, as a matter of reasonable business judgment, likely to maximize the sale price. Such procedures must not chill the receipt of higher and better offers and must be consistent with the seller’s fiduciary duties. Such procedures include the following:\(^3\)

1. Qualification of Bidders.

An entity that is seeking to become a qualified bidder will deliver financial information by a stated deadline to the debtor and other key parties (ordinarily excluding other bidders)\(^4\) reasonably demonstrating such bidder’s ability to consummate a sale on the terms proposed. Such financial information, which may be provided confidentially, if appropriate, may include current audited or verified financial statements of, or verified financial commitments obtained by, the potential bidder (or, if the potential bidder is an entity formed for the purpose of acquiring the property to be sold, the party that will bear liability for a breach). To be qualified, a prospective bidder also may be required by a stated deadline to make a non-binding expression of interest and execute a reasonable form of non-disclosure agreement before being provided due diligence access to non-public information.

2. Qualification of Bids Prior to Auction.

(A) The bidding procedures should state the criteria for a qualifying bid and any deadlines for (i) submitting such a bid and (ii) notification whether the bid constitutes a qualifying bid.

(B) The bidding procedures may require each qualified bid to be marked against the form of a stalking horse agreement or a template of the debtor’s preferred sale terms, showing amendments and other modifications (including price and other terms) proposed by the qualified bidder. However, the proposed bidding procedures ordinarily should not limit bidding to the terms of a stalking horse agreement or preferred form of

\(^3\) When multiple asset sales over time are expected, a debtor should consider seeking Court approval of global bidding procedures to avoid the need to obtain Court approval of procedures for each such sale. Similarly, the debtor should consider seeking Court approval of global notice and other appropriate procedures to facilitate sales of assets of limited value or de minimis sales that do not warrant an auction or a separate motion for each sale. What constitutes a de minimis sale will depend on the facts of each case. See Local Rule 6004-1.

\(^4\) It is expected that the debtor will also share its evaluation of bids with key parties-in-interest, such as representatives of official committees, and that it will in its reasonable judgment identify the winning bidder only after consultation with such parties.
agreement; for example, bidding on less than all of the assets proposed to be acquired by an initial, or stalking horse, bidder normally should be permitted, unless such bidding is inconsistent with the purpose of the sale.

(C) A qualified bid should clearly identify all conditions to the qualified bidder’s obligation to consummate the purchase.

(D) A qualified bid should include a good faith deposit, which will be nonrefundable if the bidder is selected as the successful bidder and fails to consummate the purchase (other than as a result of a breach by the seller) and refundable if it is not selected as the successful bidder (other than as a result of its own breach). The amount of, and precise rules governing, the good faith deposit will be determined on a case-by-case basis, but generally each qualified bidder, including any initial, or stalking horse, bidder, should be required to make the same form of deposit.

(3) **Backup Buyer.**

The Sale Procedures Order may provide that the debtor in the reasonable exercise of its judgment may accept and close on the second highest qualified bid received if the winning bidder fails to close the transaction within a specified period. In such case, the debtor would retain the second highest bidder’s good faith deposit until such bidder was relieved of its obligation to be a back-up buyer.

(4) **Stalking Horse or Initial Bidder Protections/Bidding Increments.**

(A) **No-Shop or No-Solicitation Provisions.** Limited no-shop or no-solicitation provisions may be permissible, in unusual circumstances, if they are necessary to obtain a sale, they are consistent with the debtor’s fiduciary duties and they do not chill the receipt of higher or better offers. Such provisions must be prominently disclosed in the motion, with particularity. If the relevant documents do not include a “fiduciary out” provision, the debtor must disclose the fact of and the reason for the exclusion of the provision.

(B) **Break-Up/Topping Fees and Expense Reimbursement.** The propriety of any break-up or topping fees and other bidding protections (such as the estate’s proposed payment of out-of-pocket expenses incurred by a bidder in connection with the proposed transaction or the compensation of a bidder for lost opportunity costs) will be determined on a case-by-case basis. Generally such obligations should be payable only from the proceeds of a higher or better transaction entered into with a third party within a reasonable time of the motion. Such provisions must be prominently disclosed in the motion, with particularity.

(C) **Bidding Increments.** If a proposed sale contemplates the granting of a break-up or topping fee or expense reimbursement, the initial bidding increment must be more than sufficient to pay the maximum amount payable thereunder. Additional bidding increments should not be so high
that they chill further bids, or so low that they provide insubstantial consideration to the estate.

(D) **Rebidding.** If a break-up or topping fee is requested, the Sale Procedures Order should state whether the stalking horse will be deemed to waive the break-up or topping fee by rebidding.

(5) **Auction Procedures.**

(A) If an auction is proposed, the Sale Procedures Order generally should provide that the auction will be open, with each bidder informed of the terms of the previous bid. The motion should explain the rationale for proposing a different auction format in the Sale Procedures Order.

(B) If a professional auctioneer will conduct the auction, the parties should refer to the statutory provisions and rules governing the conduct of professional auctioneers. See Bankruptcy Rule 6004 and Rules 6004-1 and 6005-1 of the Local Bankruptcy Rules for the Southern District of New York (the “Local Rules”).

(C) If the auction is sufficiently complex or disputes can reasonably be expected to arise, it is advisable at the sale procedures hearing to ask the Court whether it will consider conducting the auction in open court, or otherwise be available to resolve disputes. If the debtor proposes to conduct the auction outside the presence of the judge, the actual bidding should be transcribed or videotaped to ensure a record, or the motion should explain why this is not advisable.

(D) Each bidder is expected to confirm at the auction that it has not engaged in any collusion with respect to the bidding or the sale.

(E) The Sale Procedures Order should provide that, absent irregularities in the conduct of the auction, or reasonable and material confusion during the bidding, the Court will not consider bids made after the auction has been closed, or the motion should explain why this is not advisable.

C. **Sale Motion.**

With regard to the proposed sale, the motion and the evidence presented or proffered at any sale hearing should be sufficient to enable the Court to make the following findings: (1) a sound business reason exists for the transaction; (2) the property has been adequately marketed, and purchaser is offering to provide fair and reasonable consideration; (3) the proposed transaction is in the best interests of the debtor’s estate, its creditors, and where relevant, its interest holders; (4) the transaction has been proposed and negotiated in good faith; (5) adequate and reasonable notice has been provided; (6) the “free and clear” requirements of §363(f) of the Bankruptcy Code, if applicable, have been met; (7) if applicable, the sale is consistent with the debtor’s privacy policy concerning personally identifiable information, or, after appointment of a consumer ombudsman in accordance with §332 of the Bankruptcy Code and notice and a hearing, no showing was made that such sale would violate applicable nonbankruptcy law; (8) the requirements of §365 of the Bankruptcy Code have been met in respect of the proposed assumption and
assignment or rejection of any executory contracts and unexpired leases; (9) where necessary, the debtor’s board of directors or other governing body has authorized the proposed transaction; and (10) the debtor and the purchaser have entered into the transaction without collusion, in good faith, and from arm’s-length bargaining positions, and neither party has engaged in any conduct that would cause or permit the agreement to be avoided under §363(n) of the Bankruptcy Code.

(1) **Sound Business Purpose.**

A debtor must demonstrate the facts that support a finding that a sound business reason exists for the sale.

(2) **Marketing Efforts.**

A debtor must demonstrate facts that support a finding that the property to be sold has been marketed adequately.

(3) **Purchase Price.**

A debtor must demonstrate that fair and reasonable value will be received and that the proffered purchase price is the highest or best under the circumstances. If a bid includes deferred payments or any equity component, a debtor should discuss its assessment of the creditworthiness of competing bidders and the proposed buyer’s ability to realize the projected earnings upon which future payments or other forms of consideration to the estate are based. Any material purchase price adjustment provisions should be identified.

(4) **Assumption and Assignment of Contracts and Leases.**

A debtor must demonstrate at a minimum: (a) that it or the assignee/acquirer has cured or will promptly cure all existing defaults under the agreement(s), and (b) that the assignee/acquirer can provide adequate assurance that it will perform under the terms of the agreement(s) to be assumed and assigned under §365 of the Bankruptcy Code. Additional notice and opportunity for a hearing may be required, if the offer sought to be approved at the sale hearing is submitted by a different entity than the initial, stalking horse bidder or the winning bid identifies different contracts or leases for assumption and assignment, or rejection, than the initial bid that was noticed for approval. If this possibility exists, the sale motion should acknowledge the debtor will provide such additional notice and opportunity to object under such circumstances.

D. **Extraordinary Provisions.**

The following provisions must be disclosed conspicuously in a separate section of the sale motion and, where applicable, in the related proposed Sale Procedures Order or Sale Order, and the motion must provide substantial justification therefor:5

(1) **Sale to Insider.**

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5 The mere fact that a similar provision was included in an order entered in a different case does not constitute a justification.
If the motion proposes a sale to an insider, as defined in the Bankruptcy Code, the motion must disclose what measures have been taken to ensure the fairness of the sale process and the proposed transaction.

(2) **Agreements with Management.**

The sale motion must disclose whether the proposed buyer has discussed or entered into any agreements with management or key employees regarding compensation or future employment, and what measures have been taken to ensure the fairness of the sale and the proposed transaction in the light of any such agreements.

(3) **Private Sale/No Competitive Bidding.**

If no auction is contemplated, the debtor has agreed to a limited no-shop or no-solicitation provision, or the debtor has otherwise not sought or is not actively seeking higher or better offers, the sale motion must so state and explain why such sale is likely to maximize the sale price.

(4) **Deadlines that Effectively Limit Notice.**

If the proposed transaction includes deadlines for the closing or Court approval of the Sale Procedures Order or the Sale Order that have the effect of limiting notice to less than that discussed in II, below, the sale motion must provide an explanation.

(5) **No Good Faith Deposit.**

If any qualified bidder, including a stalking horse, is excused from submitting a good faith deposit, the sale motion must provide an explanation.

(6) **Interim Arrangements with Proposed Buyer.**

If a debtor is entering into any interim agreements or arrangements with the proposed purchaser, such as interim management arrangements (which, if out of the ordinary course, also must be subject to notice and a hearing under §363(b) of the Bankruptcy Code), the sale motion must disclose the terms of such agreements.

(7) **Use of Proceeds.**

If a debtor proposes to release sale proceeds on or after the closing without further Court order, or to provide for a definitive allocation of sale proceeds between or among various sellers or collateral, the sale motion must describe the intended disposition of such amounts and the rationale therefor.

(8) **Tax Exemption.**

If the debtor is seeking to have the sale declared exempt from taxes under §1146(a) of the Bankruptcy Code, the sale motion must prominently disclose such requested relief and be served on all taxing authorities that might reasonably be affected.

(9) **Record Retention.**
If the debtor proposes to sell substantially all of its assets, the sale motion must confirm that the debtor will retain, or have reasonable access to, its books and records to enable it to administer its bankruptcy case.

(10) **Sale of Avoidance Actions.**

If the debtor seeks to sell its rights to pursue avoidance claims under chapter 5 of the Bankruptcy Code, the sale motion must so state and provide an explanation of the basis therefor.

(11) **Requested Findings as to Successor Liability.**

If the debtor seeks findings limiting the purchaser’s successor liability, the sale motion must disclose the adequacy of the debtor’s proposed notice of such requested relief and the basis for such relief. Generally, the proposed Sale Order should not contain voluminous findings with respect to successor liability, or injunctive provisions except as provided in III, below.

(12) **Future Conduct.**

If the debtor seeks a determination regarding the effect of conduct or actions that may or will be taken after the date of the Sale Order, the sale motion must set forth the legal authority for such a determination.

(13) **Requested Findings as to Fraudulent Conveyance.**

If debtor seeks a finding to the effect that the sale does not constitute a fraudulent conveyance, it must explain why a finding that the purchase price is fair and reasonable is not sufficient.

(14) **Sale Free and Clear of Unexpired Leases.**

If the debtor seeks to sell property free and clear of a possessory leasehold interest, license or other right, the debtor must identify the non-debtor parties whose interests will be affected, and explain what adequate protection will be provided for those interests.

(15) **Relief from Bankruptcy Rule 6004(h).**

If the debtor seeks relief from the ten-day stay imposed by Bankruptcy Rule 6004(h), the sale motion must disclose the business or other basis for such request.

II. **NOTICE**

A. **General.**

Notice is always required under §363(b); however, a hearing is required only if there are timely objections or the Court otherwise schedules a hearing.
B. Notice of Proposed Sale Procedures.

(1) Notice Parties.

Notice should be limited to those parties-in-interest best situated to articulate an objection to the limited relief sought at this stage, including:

(A) counsel for official and informal committees of creditors, equity holders, retirees, etc.;
(B) office of the United States Trustee;
(C) postpetition lenders;
(D) indenture trustees;
(E) agent for prepetition lenders;
(F) entities who have requested notice under Bankruptcy Rule 2002;
(G) all entities known or reasonably believed to have asserted a lien, encumbrance, claim or other interest in any of the assets offered for sale; and
(H) parties to executory contracts and unexpired leases proposed to be assumed and assigned, or rejected as part of the proposed transaction.

To provide additional marketing of the assets, the debtor also should send a copy of the motion to entities known or reasonably believed to have expressed an interest in acquiring any of the assets offered for sale. Nothing herein is meant to imply that prospective bidders have standing to be heard with respect to the Sales Procedures.

(2) Notice Period.

As a general matter, the minimum 20-day notice period set forth in Bankruptcy Rule 2002(a) can be shortened with respect to the request for approval of a proposed Sale Procedures Order, that does not involve Extraordinary Provisions and complies with these Guidelines, without compromising the formality of the proposed transaction. The 10-day notice period provided for in Local Rule 9006-1(b) should provide sufficient time, under most circumstances, to enable any parties-in-interest to file an objection to proposed sale procedures.

(3) Contents of Notice.

Notice should comport with Bankruptcy Rules 2002 and 6004.
C. Notice of Sale.

(1) Notice Parties.

Generally the proposed sale requires more expansive notice than proposed sale procedures. (But see footnote 2, above, regarding omnibus procedures for *de minimis* sales.) Notice should ordinarily be given to: 6

(A) counsel for official and informal committees of creditors, equity holders, retirees, etc.;

(B) office of the United States Trustee;

(C) entities who have requested notice under Bankruptcy Rule 20027 (and, if the proposed sale is of substantially all of the debtor’s assets, all known creditors of the debtor);

(D) postpetition lenders;

(E) indenture trustees;

(F) agent for prepetition lenders;

(G) all entities known or reasonably believed to have asserted a lien, encumbrance, claim or other interest in any of the assets offered for sale;

(H) all parties to executory contracts or unexpired leases to be assumed and assigned, or rejected as part of the transaction;

(I) all affected federal, state and local regulatory (including, for example, environmental agencies) and taxing authorities,8 including the Internal Revenue Service;

(J) if applicable, a consumer privacy ombudsman appointed under §332 of the Bankruptcy Code; and

(K) the Securities and Exchange Commission (if appropriate).

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6 In larger cases, a sale of significant assets may also require notice of the proposed sale in publications of national circulation or other appropriate publications.

7 In the case of publicly traded debt securities, notice to indenture trustees and record holders may be sufficient to the extent that the identity of beneficial holders is not known.

8 Notice must be given to applicable taxing authorities affected by relief requested under §1146(a) of the Bankruptcy Code.
If the contemplated sale implicates the anti-trust laws of the United States, or a debt (other than for taxes) is owed by the debtor to the United States government, notice also should be given to:

(A) the Federal Trade Commission;

(B) the Assistant Attorney General in charge of the Antitrust Division of the Department of Justice; and

(C) the United States Attorney’s Office.

To provide additional marketing of the assets, notice also should be sent to any entities known or reasonably believed to have expressed an interest in acquiring any of the assets.

See I.C.4, above for circumstances in which it may be required, based on changes in the proposed transaction that had originally been noticed, to give additional notice to parties to executory contracts and unexpired leases proposed to be assumed and assigned or rejected under §365 of the Bankruptcy Code.

(1) Notice Period.

The statutory 20-day notice period should not be shortened for notice of the actual sale without a showing of good cause.

(2) Contents of Notice.

Proper notice should comport with Bankruptcy Rules 2002 and 6004 and should include:

(A) the Sale Procedures Order (including the date, time and place of any auction, the bidding procedures related thereto, the objection deadline for the sale motion and the date and time of the sale hearing);

(B) reasonably specific identification of the assets to be sold;

(C) the proposed form of asset purchase agreement, or instructions for promptly obtaining a copy;

(D) if appropriate, representations describing the sale as being free and clear of liens, claims, interests and other encumbrances (other than any claims and defenses of a consumer under any consumer credit transaction that is subject to the Truth in Lending Act or a consumer credit contract (as defined in 16 C.F.R. §433.1, as amended), with all such liens, claims, interests and other encumbrances attaching with the same validity and priority to the sale proceeds;

(E) any commitment by the buyer to assume liabilities of the debtor; and

(F) notice of proposed cure amounts and the right and deadline to object thereto and otherwise to object to the proposed assumption and assignment, or
III. SALE ORDER

The Court discourages unduly long sale orders that contain unnecessary and redundant provisions. In the typical case, the findings should be limited to those set out in I.C, supra, tailored to the particular case. The decreral paragraphs should also be limited, and if more than one decreral paragraph deals with the same subject matter or form of relief, the proponent of the Sale Order should explain the reason in a separate pleading. Finally, if the order contains a decreral paragraph that approves the purchase agreement or authorizes the debtor to execute the purchase agreement, it should not also contain separate decreral paragraphs that approve specific provisions of the purchase agreement or declare their legal effect.

With these admonitions, the Court may enter a Sale Order containing the following, if substantiated through evidence presented or proffered in the motion or at the sale hearing:

A. Approval of Sale and Purchase Agreement.

The order should authorize the debtor to (1) execute the purchase agreement, along with any additional instruments or documents that may be necessary to implement the purchase agreement, provided that such additional documents do not materially change its terms; (2) consummate the sale in accordance with the terms and conditions of the purchase agreement and the instruments and agreements contemplated thereby; and (3) take all further actions as may reasonably be requested by the purchaser for the purpose of transferring the assets.10

B. Transfer of Assets.

The assets will be transferred free and clear of all liens, claims, encumbrances and interests in such property, other than any claims and defenses of a consumer under any consumer credit transaction subject to the Truth in Lending Act or a consumer credit contract, as defined in 16 C.F.R. §433.1 (and as may be amended), with all such interests attaching to the sale proceeds with the same validity and priority, and the same defenses, as existed immediately prior to the sale,11 and persons and entities holding any such interests will be enjoined from asserting such interests against the purchaser, its successors or assigns, or the purchased assets, unless the purchaser has otherwise agreed.

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9 This notice may be provided in a separate schedule sent only to the parties to such agreements.

10 Each and every federal, state and local government agency or department may be directed to accept any and all documents and instruments necessary and appropriate to consummate the transactions contemplated by the purchase agreement.

11 If any person or entity that has filed financing statements, mortgages, mechanic’s liens, lis pendens, or other documents evidencing interests in the assets has not delivered to the debtor prior to the closing date termination statements, instruments of satisfaction, and/or releases of all such interests, the debtor may be authorized and directed to execute and file such statements, instruments, releases and other documents on behalf of such person or entity.

The debtor should try to anticipate whether there are any complex allocation issues presented by the proposed “free and clear” relief.
C. Assumption and Assignment of Executory Contracts and Leases to Purchaser.

The debtor will be authorized and directed to assume and assign to the purchaser executory contracts and leases free and clear of all liens, claims, encumbrances and interests, with all such interests attaching to the sale proceeds with the same validity and priority as they had in the assets being sold (provided, however, that in certain circumstances additional notice may be required before assumption and assignment or rejection of executory contracts and leases can be granted. See I.C.4., above.)

D. Statutory Provisions.

The proposed order should specify those sections of the Bankruptcy Code and Bankruptcy Rules that are being relied on, and identify those sections, such as Bankruptcy Rule 6004(h), that are, to the extent permitted by law, proposed to be limited or abridged.

E. Good Faith/No Collusion.

The transaction has been proposed and entered into by the debtors and the purchaser without collusion, in good faith, and from arm’s-length bargaining positions. The proposed Sale Order should also specify that neither the debtor nor the purchaser have engaged in any conduct that would cause or permit the transaction to be avoided under Bankruptcy Code §363(n).
CHAPTER 17
PROFESSIONAL RETENTION AND COMPENSATION

Some, but not all, lawyers in a bankruptcy case need court approval before they can represent their client and get paid for doing so. We begin by noting a few who do not need court approval. Then we move on to those who do.

First, if you are going to represent a chapter 7 debtor (filing the petition and schedules, showing up at the meeting of creditors, and whatever else) you don’t need court approval to take on the case or to take a fee. This is conceptually intuitive once you recall that a lawyer who represents a chapter 7 debtor represents only the debtor and not the estate, whereas, a chapter 11 debtor’s attorney represents the debtor company and its estate. The court can, however, second guess your fees and make you disgorge money later if it thinks your fee was too high. In just about every district, there is a “rack rate,” and if you come in at or below that rate, you won’t run into much trouble. Remember, though, that you must get paid up front and in advance for your pre-petition work to avoid being a preference holder or merely a general unsecured creditor of the estate.

Second, if you represent a creditor in a bankruptcy case, then for the most part, your retention and compensation is a matter between you and your client. Unless you are: (1) seeking payment of your fees from the estate for “substantial contribution” under §503(b)(3)(D) (we say a bit more about this topic below); or (2) seeking payment of the fees from the estate that would otherwise be paid to you by your client as the fees of an oversecured creditor under §506(b). If you represent another party that is not going to be paid from estate funds (such as an investor or asset purchaser, a trade vendor, an employee, etc.), you are free—subject to the ordinary ethics rules—to make your deal with the client, without court involvement. The only exception here is the need to disclose multiple creditor representations, pursuant to Bankruptcy Rule 2019.

But none of these is our primary concern. Rather, we consider here those cases where you want to get your fees directly out of the bankruptcy estate. Here you are very much under court control.

Debtor’s Bankruptcy Counsel

Section 327(a) says that “the trustee, with the court's approval, may employ one or more attorneys … to represent or assist the trustee in carrying out the trustee’s duties under this title.”

In practice, it works like this: among the papers that prospective debtors’ counsel prepares at the beginning of the case is an “Application to Employ Counsel.” It is filed, not in counsel’s name, but in the name of the client. It says, for example, that “Dawson Debtor, the debtor and debtor-in-possession in this case, hereby requests authorization to employ the firm of Ayer, Bernstein, Friedland, & Kuney to represent it as debtor’s counsel in this case.”
Conflicts Basics

Now, let’s go back and take a second look at §327(a). It provides that “the trustee…may employ one or more attorneys,” but it imposes two limitations. One, the attorney must not “hold or represent an interest adverse to the estate.” And two, she must be a “disinterested person.”

No Adverse Interest

“Adverse interest” is not defined in the Code. In our view, to understand it, you start with what you know about conflicts outside of bankruptcy. For starters, you can’t represent both plaintiff and defendant in a (nonbankruptcy) lawsuit; so also, you can’t represent both creditor and DIP in the bankruptcy case.

So far, so good. The trouble is that bankruptcy isn’t quite like nonbankruptcy litigation, and there are problems for which nonbankruptcy principles offer no analog. Most important: how aggressively may you support the interests of the old equity owners in fighting off the depredations of creditors?

There is no easy answer to this one; the best we can do is to say you can represent them some, but not too much. As DIP counsel, one of our favorite cases would be Casco Northern Bank v. DN Associates, 3 F.3d 512 (1st Cir. 1993), where the court allowed payment for a DIP counsel whose main contribution to the case appears to be that he induced senior creditors to pay prior creditors. Among our least favorite cases would be In re Kendavis Industries Intern., Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988), where the court came close to saying that anything you do other than simply paying off creditors is improper. Then again, the facts in Kendavis were extreme: the old equity owners seem to have taken the position that if they were going down, then they would be perfectly happy to take the creditors down with them—and whatever the law allows, we would concede it’s probably not that.

Disinterestedness Requirement

So much for “adverse interest.” But recall that the court must also find that counsel is a “disinterested person.” Unlike “adverse interest,” it turns out that “disinterested person” is a defined term, and the definition is stringent: See §101(14). It provides (among other things) that a “disinterested person” is one who “is not an equity security holder” and “is not…a director, officer, or employee of the debtor…” If the debtor’s pre-bankruptcy corporate counsel is (a) a two percent stockholder, and/or (b) the corporate secretary, he may be the person best equipped to represent the estate, yet on the face of things, he is disqualified. The 2005 amendments to the Bankruptcy Code deleted the per se non-disinterested person status of pre-petition investment bankers. Thus, in appropriate cases, the debtor’s pre-petition investment banker may serve as an estate professional.

Pity the law firm that is owed money for pre-bankruptcy work and that seeks to represent the debtor. It is a creditor and therefore not a “disinterested person” under §101(14). These are difficult waters to navigate. The usual approach is to get prepaid for your work during the 90 days before bankruptcy, and then draw down the advance retainer as you incur fees, so that you
are not a preference recipient and also not a creditor as of the petition date. Unfortunately, filings cannot always be timed that well, the debtor does not always have the ability to pay in advance, and the amount of fees cannot always be predicted—so it’s worth careful planning, but it doesn’t always work.

Some courts have cooked up “de minimis” exceptions and such, to get around the disinterestedness rule, which is often viewed as unduly restrictive. We are happy to be on the receiving end of such largesse, but would not recommend relying on it. If you are a creditor as of the petition date, most courts will allow you to become a “disinterested person” by waiving the claim.

**Pillowtex**

The Third Circuit in *In re Pillowtex, 304 F.3d 246 (3d Cir. 2002)*, provided a fair amount of guidance on steps that a debtor’s counsel should take (from early on) to avoid disqualification for allegedly holding an interest adverse to the debtor as a result of being a pre-petition creditor. In *Pillowtex*, the company paid $1 million in fees to its law firm in the 90-day period preceding its chapter 11 filing (apparently constituting an avoidable preferential transfer). As a potential defendant to an avoidance action, the law firm was a potential creditor, and thus did not meet the disinterestedness requirement of §327. As a result, the law firm was disqualified from the case, and all of the fees it had earned became subject to disgorgement.

A couple of guidance points here. First, do not allow accounts receivable to get past due. *Pillowtex* suggests that a law firm is at risk if it brings a past-due account receivable current during the 90 days prior to the petition date or even if it is simply collecting fees in due course prior to filing, since, in either case, payments would be made on account of an antecedent debt. Bringing a past-due account current certainly poses far less risk when done more than 90 days before the petition date. However, as noted above, the timing of a chapter 11 petition is not entirely predictable.

The best solution is this: obtain a sufficient pre-petition advance payment retainer before commencing bankruptcy work. It appears that the common practice of obtaining, and drawing against, a retainer remains acceptable. Certainly, drawing against a retainer should pose no preference issue because such draws are not “on account of an antecedent debt.” Therefore, one method of protection against a *Pillowtex*-like scenario is to obtain a sufficiently large retainer, frequently draw earned fees from that retainer, and then simultaneously request that the client replenish the retainer.

**Approval of Retention Application**

Absent conflict issues, approval of an employment application is usually pretty routine. This approval comes in the form of an order authorizing employment of counsel. Strictly speaking, only then are you allowed to represent the DIP in the case—but everybody recognizes there is a bit of slippage in the early hours or days, and you are likely to get paid for the work that you do prior to entry of the approval order, so long as your application is timely filed and does in fact get approved in due course.
To facilitate this, employment orders are typically entered to be effective as of the petition date or the date on which the employment application was filed. Some judges will enter an interim order approving the employment application, and then set the matter for a final hearing a few weeks later, to give parties more time to review and address any concerns (including, potentially, those of a committee, which may not have been appointed until a several weeks into the case). This approach allows a more careful review of an employment application, while protecting the professionals for necessary work that is done while that review is ongoing.

**Disclose, Disclose, Disclose**

The application must be accompanied by an affidavit signed by the professional, in accordance with Bankruptcy Rule 2014, setting forth, among other things, all of the professional’s connections, with the debtor, creditors, other parties-in-interest, their attorneys and accountants and the UST. This disclosure is made so that other parties, and the court, can evaluate whether there are disqualifying conflicts. Although the Bankruptcy Rules do not prescribe the exact form that the affidavit should take, the affidavits all tend to look fairly similar.

In a large case, preparing the disclosures can entail a lot of work. It is worthwhile to do this work carefully, to make sure your disclosures are complete, and to err on the side of over-disclosure. The consequences for incomplete or misleading disclosures may include disqualification, loss of compensation, and sometimes worse.

**Conducting the Conflicts Search**

We’ve seen that you cannot represent the DIP if you have certain kinds of conflicts. But you can’t deal with conflicts if you don’t know about them. In a big case (or a big firm—or both), just identifying conflicts can be a major undertaking. Here we offer a protocol designed to make sure you identify conflict problems.

At the outset of the representation, you should obtain lists from the company of its top creditors and other conventionally adverse parties. The scope of the search categories can be narrowed, within reason, by using parameters such as “Top 50” or “in the last three years,” depending upon the circumstances. These categories may include, but are not necessarily limited to, any or all of the following: (a) present and former directors and officers, (b) landlords and tenants; (c) key customers; (d) primary vendors; (e) largest unsecured creditors; (f) secured creditors; (g) other professional services firms; (h) insurers; (i) major securities holders; (k) litigation counterparties; and (l) parties to key contracts.

As the data comes in from the company, you’ll then need to cross-reference it against your client database, and generate a report that reflects your search results.

When a name is identified as a current client of your firm, the usual course of action is to disclose the client-relationship in general terms on the disclosure exhibit to your retention affidavit. The disclosure usually goes something like “Ayer, Bernstein, Friedland & Kuney represents Acme Tire Company, a key vendor of the debtor, in corporate and transactional matters unrelated to the debtor.”
Of course, the appropriate level of detail for each disclosure will vary based upon the circumstances. For instance, where a particular client relationship is more suspect and more likely to become adversarial (e.g., where the law firm represents the non-debtor parent or significant equity-holder), it is a good idea to address the issue in detail in the actual text of the affidavit (as opposed to a cursory two-line statement in an exhibit).

As the bankruptcy case progresses, it is important to remember that, as debtor’s counsel, you’ll have a duty of continuing disclosure. This means that if a potentially adverse relationship between the debtor and another client was either unknown to you at the time you submitted the original retention affidavit or later developed as a result of unforeseen events, you should file a supplemental affidavit that discloses the existence of such relationship. As with the initial disclosures, this supplemental disclosure should be viewed as an opportunity to get everything out on the table and avoid the appearance of impropriety that might otherwise arise if the relationship was uncovered by another party.

Handling Actual Conflicts of Interest

With that said, it is important to understand that debtor’s counsel is not prohibited from the ongoing representation of key parties in interest. What is prohibited is representing such parties in matters adverse to the debtor (e.g., filing a proof of claim in the debtor’s bankruptcy case).

In these situations, one preferable fix is to retain conflicts counsel to represent the DIP in matters where the actual conflict of interest exists between the DIP and one of your firm’s other current clients. Conflicts counsel is then available to handle one-off matters (e.g., claims objections, avoidance actions) that will be brought against your other clients by the DIP. If local counsel has been retained in the case, such firm often serves this dual capacity as well. When you’re drafting your retention affidavit, it is usually best to expressly note that your firm will not represent such clients in any matters adverse to the DIP (and vice versa) and that, should such matters arise, conflicts counsel will represent the DIP in such regard.

An additional point of note is that often times when a holding company files for chapter 11, some of its subsidiaries and affiliates will file along with it. In such cases, retention applications often contemplate that the professionals will be representing all of the debtors, not just one. This raises obvious questions as to conflicts of interest (e.g., holding company debtor is largest creditor of subsidiary debtor). We don’t have the space here to give this issue its due, but the bottom line is that most courts understand that in the absence of an actual conflict, a single firm can adequately represent multiple debtors. This is also the logical result when one thinks about the expense that would be involved if the baseline rule were that each debtor in a multi-debtor enterprise be represented by separate counsel.

Getting Paid

Obtaining approval of the employment application is a good start; but it is not the end. There is still the matter of fees. The statute allows “(a) reasonable compensation for actual, necessary services rendered…and (b) reimbursement for actual, necessary expenses.” See
§330(a)(1). So even though authorized to represent the estate, you need to make a separate application to get paid. The statute specifies that “the court may allow compensation different from the compensation (provided for in the employment application) if [those terms] prove to have been in provident light of developments not capable of being anticipated at the time of employment approval. See §328.

Fee Applications

Given these constraints, getting a fee award is far from automatic. We all know about the public complaints against allegedly excessive bankruptcy fees. We are acquainted also with the defense from lawyers who argue that they add value and should be well compensated, in order to attract talented professionals to the bankruptcy practice. We won’t get into that mare’s nest here. Suffice it to say that anyone who wants to get paid for representing the DIP had better be prepared to keep full and accurate time records (usually in tenth-of-an-hour increments), and to be able tell a plausible story as to why his services are in fact worthy of reward.

In filing a fee application, you should review the court’s local rules and UST’s guidelines to make sure you provide the information the court requires in the proper format and that you don’t seek fees or expenses of a kind that the court does not permit. Local rules vary, but some courts have limits on fax charges, meal expenses, billing travel time, compensation for time spent preparing fee applications, and other sorts of expenses. See http://www.usdoj.gov/ust/guidlines.htm.

In §330(a)(3), there is a list of “factors” that the court may consider in setting fees. The statute lists six factors, and specifies that list is not exclusive. Some court decisions have listed more factors; a much-cited classic list is in Johnson v. Georgia Highway Exp., Inc., 488 F.2d 714, 717 (5th Cir. 1974). It is often a good idea to address these factors in your fee application, although the list of factors should not constrain you from telling the story of how your work benefited the estate.

Any party in interest can object to an interim or final fee application. USTs tend to be particularly active in this area, perhaps believing that other lawyers in the case may not be sufficiently vigilant in policing each other’s fees. Even without objections, judges may raise issues and concerns of their own.

Interim Payment

In a simpler time, at least in smaller cases, you had to wait until the end of the case and take your fees out of the final distribution. Maybe that is still true today somewhere, but we know of no such place. Courts typically permit some sort of mechanism for “interim fees.” This is contemplated by §331, which provides for interim fee applications once every 120 days, or more often if the court permits. In large cases, even the 120 day delay can be a burden on professionals. As a result, many courts will enter orders permitting monthly payment of undisputed fees and expenses, subject to a holdback (a typical arrangement might be 80-85 percent of fees and 100 percent of expenses). You still need to file interim and final fee applications, but the monthly compensation orders help with the cash flow issues.
“Local” vs. “National” Rates

In recent years, professional service firms with national reputations and extensive experience representing debtors in large chapter 11 cases have captured a large share of the market. When a bankruptcy case is filed in a city where a local professional typically charges lower hourly rates than national firms charge, an issue arises whether such national firms may be compensated at their customary hourly rates. This is known in the business as the “national rate vs. local rate” debate. For the most part, however, this debate appears to be coming to a close, with most bankruptcy courts and USTs recognizing that compensation should be based on the customary rates the retained firm typically charges. If you look at the legislative history, you will see that it supports this result.

Nonetheless, it is important to be aware that certain courts to this day will enforce the local rate rule. And, if you find yourself considering filing in one such jurisdiction, it would behoove you to be well-versed in the relevant case law and prepare to support your compensation as “reasonable,” in the event that such a challenge arises.

Priority of Payment

The bad news is that you have to jump through all of these hoops to get paid. The good news is that when your fees do get approved, in a business case you are at or very near the head of the queue. The Bankruptcy Code provides for a schedule of priorities in distribution: §507(a)(2) provides that priority goes to “administrative expenses” over all other unsecured claims other than those of domestic support obligations or trustee fees. Your allowed fees for services in representing the DIP count as an “administrative expense.”

Beware of Conversion

However, the administrative expense priority is not necessarily the end to all your troubles. One hundred percent of nothing is still nothing, and you get your priority payment only if there is enough to pay administrative expenses. Here is a nightmare: the chapter 11 collapses into chapter 7. Administrative expenses for the chapter 7 trump the administrative expenses for chapter 11, so you may find that the estate is administratively insolvent—there’s not enough money to pay all chapter 11 administrative expenses in full—or sometimes at all. It is typical (and usually quite prudent) for the DIP’s counsel to get a pre-petition retainer in order to deal with this risk. This is a good idea, although it usually just limits, rather than eliminates, the risk.

Obtaining the Carve Out

Another risk may be even more common—that the estate’s only assets will be fully encumbered by a secured creditor’s (or DIP lender’s) first priority lien. If the secured creditor is undersecured, there will be nothing left to pay professional fees. To deal with this risk, professionals usually negotiate a “carve out” to provide for payment of their allowed fees. The carve out is essentially an agreement by the secured creditor to subordinate its lien and claim to certain allowed professional fees, permitting such fees to come first in line in terms of payment from the estate’s assets.
The carve out may be subject to a dollar amount cap and also to restrictions on the services that can be paid from the carve out (i.e., usually one cannot use the carve out to sue the secured lender who agreed to it). As a practical matter, the secured lender usually agrees to the carve out because otherwise nobody will represent the debtor (or committee) and the case will fall apart, further diminishing the overall value of the secured lender’s collateral. These carve outs are very common, but they are not automatic. Make sure you negotiate a carve out up front, and obtain proper court approval through the applicable first day financing motion (e.g., motion to approve cash collateral stipulation). Otherwise, you may find, at the end of the case, that you did a lot of free work, mostly for the benefit of the secured creditor.

Bankruptcy Code §503 and Substantial Contribution

There is another route to compensation via §503, the section that governs administrative expenses. Bankruptcy Code §503(b)(3)(D) allows compensation to “a creditor” who makes “a substantial contribution” to a chapter 11 case. Bankruptcy Code §503(b)(4) allows compensation for his attorney. But don’t count on it in lieu of a proper retention. What is a “substantial contribution” in your eyes may not appear so to others who believe you were merely protecting your client’s interests.

Special Counsel

Bankruptcy Code §327(e) authorizes the trustee to appoint a firm as special counsel for a particular purpose. The typical example would be the case where debtor’s counsel is in the midst of litigation on the debtor’s behalf when the chapter 11 begins. The debtor wants to use that same counsel to complete the litigation. The appointment still needs court approval, but the conflict rules are less stringent. Just as before, counsel must have no “adverse interest,” but in this case only “with respect to the matter on which such attorney is to be employed.” There is also no “disinterestedness” requirement.

It is thus much easier to qualify under §327(e) than under §327(a). But courts have been alert to prevent counsel from using §327(e) as an end run around §327(a): you can’t be “special counsel” for the purpose of “generally representing the DIP.” By its language, §327(e) also seems only to apply to lawyers, and not to, say, accountants who cannot satisfy the disinterestedness standard, but may have a special role they are particularly well qualified to play. On occasion, a judge will “bend” this rule to permit a non-lawyer to be retained under §327(e).

Non-Lawyers and Bankruptcy Code §327(a)

When lawyers talk about §327(a), the conversation tends to focus on the matter of fees for counsel who represent the DIP. Its scope is broader than that. In fact, §327(a) speaks of “attorneys, accountants, appraisers, auctioneers or other professional persons.” Not surprisingly, there is a good deal of activity relating to the employment of these other professionals, and other professionals. Some of this concerns what sort of people are “professionals” who need court approval to be retained. We have seen, for example, real estate brokers end up working for free because nobody told them to seek approval of their retention in advance. A court may sometimes
stretch to approve compensation for someone who was not retained in advance, perhaps through retroactive retention order or on a quantum meruit basis—but, again, don’t count on it.

In large cases where a debtor employs many professionals, the court will sometimes enter an order authorizing the employment of “ordinary course” professionals, in order to avoid having to consider a multitude of employment applications for professionals who perform routine services. Typically these are subject to a monthly compensation cap (both for each individual professional and for all such professionals in the aggregate), to assure that any of the substantial professional retention are approved by the court on an individual basis.

**Potential Retention and Fee Payment Alternatives for Financial Advisors and Investment Bankers**

Another issue with respect to §327(a) retention involves investment bankers and financial advisors, who typically don’t like to keep records in quarter or tenth of an hour increments and also often charge flat monthly fees plus success fees rather than hourly fees. Some courts resist this, in part because it is difficult for the court to evaluate the work performed and the “value” conferred without time records and in part because the fees are sometimes enormous.

In addition, financial advisors are often employed by distressed companies prior to the bankruptcy filing, sometimes in the capacity of corporate officers. This has caused problems when the filing takes place and the DIP seeks to employ the same advisor via §327(a).

In such cases, some DIPs will file a motion pursuant to §363 seeking to approve a post-petition engagement agreement with the financial services firm. Bankruptcy Code §363 does not have §327(a)’s disinterestedness and no adverse interest requirements. Technically, the motion need only be shown to be in the best interests of the estate. Nevertheless, to hedge against likely objections from the U.S. Trustee that the DIP is attempting an end run of §327(a), most DIP’s will submit supporting affidavits from the financial advisor similar to those required in §327(a) retentions, disclosing the nature of the past and present relationship, and any potentially adverse interests. In addition, such §363 retentions are not subject to fee application requirements—the avoidance of which, as noted above, is usually an important objective of financial advisors.

The likelihood of success of this alternative approach will depend, in large part, upon the particular court and corresponding region for the UST where the case is located. Higher traffic jurisdictions such as S.D.N.Y. and Delaware are more familiar with such §363 motions and, as a result, tend to be more agreeable to their use.

**Using Bankruptcy Code §328 for Locking in Approval of Success Fees**

In some cases, financial advisors and investment banking firms, in particular, will try to utilize §328 to obtain approval of lump-sum success or transaction fees. Section 328 authorizes the employment of a professional person under §327 “on any reasonable terms and conditions of employment, including a retainer, on an hourly basis, on a fixed or percentage fee basis or on a contingency fee basis.” Unlike the standard §327 retention, if a fee arrangement has been
approved under §328, a court cannot “reduce the resulting fee unless the terms of the court’s approval ‘prove to have been improvident in light of developments not capable of being anticipated’ when approved.”

This predictability of compensation makes §328(a) very attractive to a financial advisor if the fee arrangement involves incentive based compensation. Some courts will accept this. Others may be resistant to any effort by a professional to limit the court’s ability to evaluate the value of services rendered with the benefit of hindsight.

Committee Professionals

Paralleling §327, §1103 provides that a creditor’s committee in a Chapter 11 case may appoint counsel and other professionals. Bankruptcy Code §§328 and 330 specify that the committee’s professional fees, too, will be a charge against the estate. The same sort of adverse interest rules apply, with a notable exception—the disinterestedness requirement does not apply, just the adverse interest test. And, because the most obvious candidate for committee counsel may be a lawyer who previously represented an individual creditor, §1103 specifies that representation of one or more individual creditors will not be an adverse interest that per se prevents the lawyer from representing the committee. It does, however, provide that he cannot represent the individual creditor at the same time that he is representing the estate.
APPENDIX 17(a)
IN RE: CONGOLEUM CORP.

426 F.3d 675 (3rd Cir. 2005)

In this pre-packaged chapter 11 reorganization, we hold that evidence of pre-petition conduct in this case by a law firm is relevant to a review of a debtor’s application to retain the firm as special insurance counsel. We conclude that the bankruptcy judge should not have granted the application here. The firm had acted as counsel for the debtor pre-petition in negotiating settlement arrangements with asbestos injury claimants represented by attorneys who were co-counsel with the firm in insurance matters for those same claimants. We conclude that conflicts existed which precluded the firm’s retention under the Rules of Professional Conduct and the Bankruptcy Code.

Facing nearly 100,000 claims for injury caused by asbestos in its products and the exhaustion of its primary liability insurance coverage, Congoleum filed a declaratory judgment in the Superior Court of New Jersey in 2001 against a number of excess carriers. The complaint was filed by the law firm of Dughi, Hewit & Pallatucci, which had represented Congoleum in insurance matters for more than ten years.

While that litigation continued, Congoleum sought relief in the Bankruptcy Court in a chapter 11 pre-packaged plan of reorganization designed to channel existing and future asbestos claims to a trust as authorized by 11 U.S.C. §524(g). Approval of the plan would enable Congoleum to preserve its assets and continue in business because the trust would assume its asbestos liability. Section 524(g) of the Bankruptcy Code requires that 75 percent of current asbestos claimants approve a plan of reorganization before a channeling order may be issued. As a result, garnering support from a large number of claimants is crucial to the success of a plan.

A unique feature of asbestos personal injury litigation is the fact that a small group of law firms represents hundreds of thousands of plaintiffs. Another notable aspect is that, because over time they may have been exposed to asbestos in various environments, some of the injured persons may have claims against a number of defendants.


2 We take judicial notice of the state court proceedings insofar as they are relevant here. See Furnari v. Warden, Allenwood Federal Correctional Inst., 218 F.3d 250, 255 (3d Cir. 2000); In re Indian Palms Assoc., Ltd., 61 F.3d 197, 205 (3d Cir. 1995) (concluding that judicial notice can be taken of certain facts such as that a document was filed, a position taken, an admission or allegation made “as long as it is not unfair to a party to do so and does not undermine the trial court’s factfinding authority.”).

3 Congoleum Corporation, Congoleum Sales, Inc. and Congoleum Fiscal, Inc. filed for bankruptcy. We will refer to those entities as “Congoleum.”
The realities of securing favorable votes from thousands of claimants to meet the 75 percent approval requirement forces debtors to work closely with the few attorneys who represent large numbers of injured claimants. A prepackaged plan of reorganization acceptable to the debtor must be satisfactory for the claimants as well and, consequently, extensive negotiations are necessary.

I.

In this case, negotiations between the debtor and counsel for plaintiffs produced a proposal that involved the creation of a trust funded primarily by proceeds from Congoleum’s insurance carriers to pay for settlements of existing, as well as future asbestos personal injury claims. Congoleum was to contribute to the trust a $2.7 million promissary note payable ten years after confirmation and ABI, Congoleum’s parent corporation, was to contribute $250,000 cash and the pledge of its shares in Congoleum to secure Congoleum’s promissory note. Notably, neither Congoleum nor related entities were required to contribute equity to the trust.5

The pre-petition activity that occurred in this case is fairly typical of that in a number of asbestos pre-packaged plans. Joseph F. Rice and Perry Weitz, two plaintiffs’ lawyers,6 negotiated a settlement of numerous asbestos claims with Congoleum’s counsel, Gilbert, Heintz

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4 Pre-packaged bankruptcies employing a channeling injunction are not eligible for the “cram down” provision contained in 11 U.S.C. §1129(b)(1) which allows the bankruptcy court to confirm a plan of reorganization over creditors’ objections in certain circumstances.

5 11 U.S.C.A. §524(g) provides for the bankruptcy channeling injunction and subsection (2)(B) contains the requirements for the injunction; it requires that -

(i) the injunction is to be implemented in connection with a trust that, pursuant to the plan of reorganization—

(I) is to assume the liabilities of a debtor…;

(II) is to be funded in whole or in part by the securities of 1 or more debtors involved in such plan and by the obligation of such debtor or debtors to make future payments, including dividends;

(III) is to own, or by the exercise of rights granted under such plan would be entitled to own if specified contingencies occur, a majority of the voting shares of -

(aa) each such debtor;

(bb) the parent corporation of each such debtor; or

(cc) a subsidiary of each such debtor that is also a debtor; and

(IV) is to use its assets or income to pay claims and demands; ...

11 U.S.C.A. §524(g) (emphasis added).

6 Perry Weitz is a partner in the law firm of Weitz & Luxenberg, P.C. Joseph Rice is a partner in the law firm of Motley Rice, LLC. Those two firms represent hundreds of thousands of asbestos claimants. Weitz and Rice executed the Claimant Agreement as representatives of participating asbestos claimants.
Appendix 17(a) - In re Congoleum Corp.

& Randolph, LLP (“Gilbert”). The agreement employed a matrix to “resolve and settle” the amounts the various classes of claimants would receive as damages. For example, mesothelioma victims were each allocated $100,000. In contrast, those with non-malignant injuries would receive $1,000.7

To qualify for compensation, a participating claimant was required to provide evidence of injury and exposure to Congoleum products. Claims of the qualified participating claimants would be secured to 75 percent of the matrix values and the remainder would be treated as unsecured claims. In contrast to the claims of participating claimants addressed in the settlement agreement, claims settled with a separate group of claimants pre-petition would be secured in full.

II.

The role Gilbert played in preparing the plan is challenged in this proceeding. In October 2002, Perry Weitz recommended that Congoleum retain Gilbert to assist in solving insurance coverage for Congoleum’s mounting asbestos liability. Gilbert specializes in insurance coverage disputes and product liability matters. It serves in a variety of capacities related to various asbestos mass tort cases and represents defendants as well as claimant and creditor committees in various asbestos bankruptcies.

At the time he recommended the firm to Congoleum, Weitz had existing co-counsel relationships with Gilbert in other asbestos related proceedings.8 The arrangements were that Gilbert would represent the claimants in seeking recovery from the insurers of asbestos defendants.

Gilbert described its work as co-counsel with Weitz as providing:

“insurance-related advice to certain claimants in asbestos and other contexts. [Gilbert] represents certain asbestos-related bodily injury claimants in proceedings against a primary insurer with respect to that insurer’s coverage obligations . . . in pursuing coverage claims against insurers . . . and in pursuing coverage from insurers of similar defendants.”

7 The settlement amounts were assigned as follows:

(1) mesothelioma - $100,000;
(2) lung cancer - $30,000;
(3) other cancers - $10,000;
(4) Level II non-malignant disease - $3,000; and
(5) Level I - nonmalignant disease - $1,000.

8 Perry Weitz’s suggestion that Congoleum contact Gilbert occurred in the midst of negotiations of claims against Congoleum by two individuals suffering from mesothelioma, Messrs. Cook and Arseneault.
Gilbert explained that it did not represent the individual claimants with respect to the establishment of their tort claims, “but only with respect to the collection of insurance monies to pay claims that may be established.”

On Feb. 6, 2003, Gilbert entered into a formal retention agreement to advise and represent Congoleum in efforts to negotiate with claimants’ counsel to settle “pending asbestos-related bodily injury” claims, and arrange for the “terms of a ‘pre-packaged’ plan of reorganization.” For these services, Gilbert was to receive a fixed fee of $2 million from Congoleum. Congoleum also paid Perry Weitz and Joseph Rice$1 million each for fees and expenses they “incurred or may incur in connection with” negotiating the pre-packaged plan.

In its letter of retention, Gilbert disclosed to Congoleum its many representations in the asbestos field, including that it had been retained to represent individual tort claimants “to provide legal advice with respect to insurance matters.” Gilbert explained that its “co-counsel with respect to many of these matters is [Weitz].” Gilbert also stated that it represents other clients, not listed here, that are or may be adverse to the [sic] Congoleum with respect to asbestos related claims. GHR will continue to represent these and other similarly situated clients in these capacities in the future...In light of the Firm’s representation of entities that are potentially adverse to Congoleum in other matters, GHR cannot provide any legal services to Congoleum that could impair its ability to represent fully its corporate and other clients. Congoleum agrees that GHR may continue to represent or to undertake to represent existing or new clients as described above or in other matters, even though the positions taken by other clients in those matters may be adverse to the positions taken by Congoleum in those or other matters. Congoleum will not, in [sic] the basis of GHR’s representation of them, object to GHR’s continuing or undertaking the representation of other clients in matters where the positions taken by such clients are adverse to those taken by Congoleum in those or other matters.

In addition to negotiating on Congoleum’s behalf with claimants’ counsel to structure the contemplated bankruptcy reorganization, Gilbert participated in the declaratory judgment action in New Jersey state court, although the Dughi firm is the lead trial counsel in that proceeding.

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9 No party has raised objections to the fees of $2 million payable to Gilbert and the $1 million each payable to Weitz and Rice. That matter is not before us and we do not rule on it at this point.

In In re Combustion Eng’g, Inc., 295 B.R. 459 (Bankr. D. N.J. 2003) (vacated on other grounds, 391 F.3d 190 (2004)), a pre-packaged asbestos bankruptcy case, Joseph Rice sought a $20 million fee for his pre-petition work. That fee was to be paid by a corporation affiliated with the debtor, but was disallowed by the bankruptcy judge because Rice had a conflict of interest.

In In re Pittsburgh Corning, 308 B.R. 716 (Bankr. W.D. Pa. 2004), the bankruptcy court refused to allow a fee of $30 million to be received by Gilbert in representing the asbestos claimants’ committee. The judge found Gilbert had a conflict of interest in that pre-package asbestos proceeding.
Congoleum filed its reorganization petition on Dec. 31, 2003 and on Jan. 23, 2004 applied for bankruptcy court approval to retain Gilbert as “special insurance counsel.” The application stated that Gilbert “would be primarily responsible for strategic advice on insurance issues, including but not limited to insurance-related settlement negotiations, and the representation of the Debtors with respect to insurance issues arising in the context of the Chapter 11 Cases.”

The application continued, “GHR was the primary counsel that negotiated with representatives of asbestos plaintiffs to create the structure of the Debtors’ Plan. GHR also represented Congoleum in negotiating and drafting asbestos settlement agreements that liquidated numerous claims asserted against Congoleum in the tort system. The settlement of numerous asbestos claims allowed the Debtors to negotiate the Plan, which contemplates that the primary assets dedicated to pay asbestos claims will be Congoleum’s right to receive insurance proceeds.”

The following services “among other things” were to be provided by Gilbert:

(a) advising and representing the Debtors in insurance-related settlement negotiations and mediations with insurers and other parties;

(b) pursuant to request of the Debtors, advising and assisting the Debtors in consultations with parties-in-interest regarding unresolved, potentially available insurance coverage;

(c) advising the Debtors as to the appropriate steps necessary to assert claims against and obtain proceeds from insurers;

(d) reviewing and analyzing insurance-related documents, data, applications, orders, operating reports, schedules and other materials;

(e) representing the Debtors at hearings concerning insurance-related issues in the bankruptcy case;

(f) advising and assisting the Debtors in preparing appropriate insurance-related legal pleadings and proposed insurance-related orders in the bankruptcy case;

(g) pursuant to requests of the Debtors, advising and assisting the Debtors with respect to insurance-related issues in connection with the formulation negotiation and confirmation of a plan of reorganization;

(h) pursuant to requests of the Debtors, assisting and advising the Debtors generally with respect to insurance-related issues during the Chapter 11 Cases, and such other services as may be in the best interest of the Debtors; and
(i) preparing appropriate pleadings and orders, conducting discovery, and representing Congoleum in the Coverage Litigation (if the automatic stay is not maintained) or in any adversarial proceeding relating to the determination of insurance rights or collection of insurance claims; provided, however, that the Debtors anticipate that [Dughi] will continue to act as primary litigation counsel in the Coverage Litigation and GHR’s role in this regard will consist of coordinating the Coverage Litigation with insurance settlement efforts and assisting [Dughi] as required.

Certain of Congoleum’s liability insurers who had not participated in the formulation of the plan objected to the application to retain Gilbert. They alleged that Gilbert was in conflict because of the duties it owed the individual claimants it represented as co-counsel with Weitz. The insurers also pointed out that the Kenesis Group, LLC (“Kenesis”), a third party owned 70 percent by Gilbert and hired pre-petition by Congoleum to screen claimants, had already been disqualified from being retained to review claims in *In re ACandS, Inc.*, 297 B.R. 395 (Bankr. D. Del. 2003), a proceeding in which Gilbert had been involved. They argued that Gilbert’s extensive relationship to Perry Weitz and Joseph Rice in other asbestos matters violated both the disinterestedness requirement of §327(a) of the Bankruptcy Code and the Rules of Professional Conduct. Moreover, the details of the fee arrangement between Gilbert and Weitz had not been disclosed. The insurers also asked for discovery to further explore Gilbert’s relationship with other parties involved in the bankruptcy.

On March 1, 2004, the bankruptcy judge heard argument on Congoleum’s application to retain Gilbert. The United States Trustee appeared and stated that he did “not object to Gilbert Heintz’ retention.” The Trustee conceded, however, that “there are certainly potential conflicts. And when it’s potential under Marvel, there’s a weighing of whether it’s going to become actual or not…and we need to see what happens here.”

Gilbert contended that its conduct pre-petition was not relevant to its employment as special counsel. It argued that, as to the matters listed in the application, the interests of the individuals it represented as co-counsel with Weitz were aligned with Congoleum’s interests to obtain recovery from the insurers.

The bankruptcy judge granted the application to employ Gilbert, holding that the standards set in §327(e) of the Bankruptcy Code, rather than those in §327(a), applied and, hence, the requirement of disinterestedness of §327(a) was not pertinent. The judge noted the difference between pre-and post-petition representation and said,

> whatever else may have gone on in the pre-petition negotiations, even if GHR was bad, bad, bad, now today, both the Debtor and GHR want to preserve and maximize the Debtor’s insurance assets. I’m not making a finding about whether GHR acted improperly pre-petition.

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10 *In re Marvel Entertainment Group*, 140 F.3d 463 (3d Cir. 1998).
I’m just saying that its pre-petition behavior cannot carry the day on a post-petition retention application for different services.

In addition to the challenge to Gilbert’s retention, the insurers also contested Congoleum’s employment of Kenesis Group, LLP as consultants and claim processors. Gilbert owned a 70 percent interest in Kenesis. Congoleum had paid $1,678,000 for Kenesis’ work screening asbestos claimants. Congoleum’s application described Kenesis’ work pre-petition, indicating that it would continue to review claims it had previously processed and determined to be deficient to determine whether the defects had been cured. In addition, the application indicated that Kenesis would perform consulting services for Congoleum’s law firms, including Gilbert and Dughi.

On April 5, 2004, about one month after granting Gilbert’s application, the Bankruptcy Court heard argument on the Kenesis application. In response to the objections from Congoleum’s insurers and the United States Trustee, the Court denied the application. The bankruptcy judge based her denial on the “concern that Kenesis [was] not disinterested due to its relationship with [Gilbert].” The judge noted that Kenesis had been involved in “negotiating the Claimant Agreement [pre-petition] and that forms the backbone of the reorganization plan. So the Court finds that they were and continue to be involved in negotiating the plan.”

The bankruptcy judge further expressed concern that Kenesis might have a conflict of interest with the debtor because the payment it received for pre-petition services might be a preference. Moreover, the court shared “the U.S. Trustee’s concern that Kenesis is not disinterested due to its relationship with GHR. The prospect that GHR would be reviewing the work product of an entity with such a strong overlap of identity is still more reason that Kenesis does not meet the standards of §327.”

The insurers appealed the ruling on Gilbert’s retention. The District Court concluded that the bankruptcy judge was correct in her rulings on the alignment of interests and the application of §327(e). The district judge commented that because the insurance companies were the primary source of funds to pay claimants, the carriers “have every interest in making it, to put it bluntly, difficult to confirm this bankruptcy, and that motivation is not lost on the Court.”

In their appeal to this Court, the insurers raise several issues including: (1) whether the District Court erred in affirming the Bankruptcy Court’s determination that retaining Gilbert violated neither the Bankruptcy Code nor the Rules of Professional Conduct; (2) whether the District Court erred by affirming that §327(e) of the Bankruptcy Code applied rather than §327(a); (3) whether the District Court erred in not reversing the Bankruptcy Court’s findings of fact and conclusions of law where the Bankruptcy Court neither conducted an evidentiary hearing nor allowed discovery; (4) whether the District Court erred by failing to consider Gilbert’s economic and other ties to lawyers representing asbestos claimants who are adverse to

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11 Kenesis subcontracted its work to The Clearinghouse LLC, an organization owned by an individual who was on leave of absence from a position as a paralegal at Joseph Rice’s law firm. Kenesis purchased The Clearing House before beginning claims review work for Congoleum.
Congoleum; and (5) whether the District Court erred by affirming the Bankruptcy Court’s denial of the insurers’ Motion for Judicial Notice.

Congoleum questions whether the insurers have standing to challenge the retention of special insurance counsel.

III.

This is a core proceeding pursuant to 28 U.S.C. §157(b)(2). The District Court had jurisdiction pursuant to 28 U.S.C. §§157 and 1334. We have before us a final order which we review under 28 U.S.C. §1291. In re United Artists Theatre Co. v. Walton, 315 F.3d 217 (3d Cir. 2003); Staiano v. Pillowtex, Inc. (In re Pillowtex, Inc.), 304 F.3d 246 (3d Cir. 2002).

Because we are a court of appeals, “twice removed from the primary tribunal, we review both the factual and the legal determinations of the district court for error.” In re BH & P, Inc., 949 F.2d 1300, 1305 (3d Cir. 1991) (quoting Universal Minerals, Inc. v. C.A. Hughes & Co., 669 F.2d 98, 101-02 (3d Cir. 1981)). In order to determine whether the District Court erred, we review the bankruptcy court’s findings by the standards the District Court should have employed. Id. at 1306.

IV.

At the outset we must consider Congoleum’s contention that the insurers lack standing to bring this appeal. Congoleum argues that the insurers are not creditors of the debtor, are not persons aggrieved by the retention order, and under the more restricted bankruptcy standards, lack appellate standing. In support of its position, Congoleum cites Travelers Insurance Company v. H.K. Porter Company, Inc., 45 F.3d 737 (3d Cir. 1995) and In re Dykes, 10 F.3d 184 (3d Cir. 1993).

Article III standing need not be financial and only need be fairly traceable to the alleged illegal action. See Miller v. Nissan Motor Acceptance Corp., 362 F.3d 209, 221 (3d Cir. 2004) (listing the elements of Article III standing). In the bankruptcy field, however, we have adopted a jurisprudential rule that limits appellate standing to persons or entities that are aggrieved by an order which diminishes their property, increases their burdens, or detrimentally affects their rights. Travelers, 45 F.3d at 742.

We cited the standing distinction in In re Combustion Engineering, Inc., 391 F.3d 190 (3d Cir. 2005). We recognized the acute need to limit appeals in bankruptcy cases which often involve a myriad of parties indirectly affected by every bankruptcy court order. Combustion Engineering involved a pre-packaged Chapter 11 plan similar to the one before us. We concluded that some of the insurers had appellate standing but only with respect to the limited group of issues that affected them. Id. at 217-18.

Here, the insurers are entitled to standing even under the more restrictive standard applied to bankruptcy proceedings. The retention of special insurance counsel is an important preliminary matter that will profoundly affect the determination of the validity of a proposed plan ab initio. It is an issue based on procedural due process concerns that implicate the integrity
of the bankruptcy court proceeding as a whole. The retention of Gilbert as special insurance counsel will affect the resolution of issues that may directly affect the rights of insurers and fairness to the asbestos claimants.

_Combustion Engineering_ and _Dykes_, on the other hand, were appeals from final orders confirming plans of reorganization. In _Travelers_, the objections were directed at an order reinstating certain claims. In the present case, the appeal is from an order which will affect the fairness of the entire bankruptcy proceeding, including the determination of issues such as those for which we granted insurer standing to challenge a final order in _Combustion Engineering_.

Further, it is extremely important to resolve this preliminary matter now; otherwise, it may never be addressed.

_In re Marvel Entertainment Group_, 140 F.3d 463 (3d Cir. 1998), presented a challenge to our jurisdiction in an appeal from an order refusing the trustee’s request to retain a certain law firm. We treated the bankruptcy judge’s order as final, pointing out that if we did not take jurisdiction at that point, no “meaningful review” of the denial of the appointment could ever take place. _Id._ at 470.

We observed that once a plan has proceeded to confirmation, orders involving retention of professionals are unlikely to get the attention they deserve. Once a bankruptcy reorganization has been completed, it would be unlikely that the proceedings would commence again from the beginning to correct preliminary issues. _Id.; see also In re Amatex Corp., 755 F.2d 1034, 1040 (3d Cir. 1985) (noting that “waiting until a final plan is approved may well cause several years of hearings and negotiations to be wasted”); Official Comm. of Asbestos Claimants v. G-I Holdings, Inc. (In re G-I Holdings, Inc.), 385 F.3d 313 (3d Cir. 2004) (reviewing an order appointing a trustee prior to plan confirmation). Addressing the challenges to Gilbert’s retention at this stage comports with our discussion of the unlikelihood of review late in a bankruptcy in _Marvel_ as well as the concern for fairness and due process throughout complex bankruptcy proceedings such as this one.

In addition, counsel for the insurers has a responsibility, if not a duty, to alert the Court to ethical conflicts. Rules governing professional conduct are often viewed as even more necessary and applicable in bankruptcy cases than in other contexts. See _1 Collier on Bankruptcy_ (15th ed.) P 8.01[1] (“Thus the importance of adherence to the ethical rules, as well as disclosure, initial and continuing, cannot be overemphasized.”).

There are, of course, concerns about the tactical use of disqualification motions to harass opposing counsel. See _Richardson-Merrell, Inc. v. Koller_, 472 U.S. 424, 436, 86 L. Ed. 2d 340, 105 S. Ct. 2757 (1985) (disqualification of counsel in a civil, not a bankruptcy appointment). Similarly, courts must be cautious about infringing on the right of the debtor to retain counsel of its choice. Nevertheless, the obligation to ensure that professional ethics are followed has led courts to rule that counsel has standing to raise and challenge unethical procedures on the part of opposing lawyers. See _Kevlik v. Goldstein_, 724 F.2d 844, 848 (1st Cir. 1984) (citing cases from the Courts of Appeals for the Fourth and Fifth Circuits authorizing attorneys to report ethical concerns to the court).
We raised, but did not decide, whether a “motion to disqualify must be brought by a former client” in *In re Corn Derivatives Antitrust Litig.*, 748 F.2d 157, 161 (3d Cir. 1984). However, we noted, “one of the inherent powers of any federal court is the admission and discipline of attorneys practicing before it.” *Id.* at 160.

The District Court in *Schiffli Embroidery Workers Pension Fund v. Ryan, Beck & Co.*, 1994 U.S. Dist. LEXIS 2154, 1994 WL 62124 (D. N.J. 1994), cited then Rule 8.1 of the New Jersey Rules of Professional Conduct, which required lawyers to report violations of the Rules of Professional Conduct. Based on that duty, the court found that a lawyer had standing to present a motion to disqualify its opposing counsel.

Rule 8.3 of the New Jersey Rules of Professional Conduct is the current version of the rule addressed in Schiffli; it provides that a lawyer who knows that another lawyer has committed a violation of the Rules of Professional Conduct that raises a “substantial question as to that lawyer’s honesty, trustworthiness, or fitness as a lawyer in other respects shall inform the appropriate professional authority.” *See also O’Connor v. Jones*, 946 F.2d 1395, 1399 (8th Cir. 1991) (“In cases where counsel is in violation of professional ethics, the court may act on motion of an aggrieved party or may act *sua sponte* to disqualify.”); *International Electronics Corp. v. Flanzer*, 527 F.2d 1288, 1295 (2d Cir. 1975) (considering the issue of attorney conflict despite failure of parties to raise the point).

We need not decide whether the insurers’ counsel had a duty to disclose Gilbert’s conduct in this case. It is enough that the insurers’ counsel had the right to raise the issue under the Rules of Professional Conduct and require adjudication by the court. Concluding otherwise would suggest that we do not support the long-standing role of lawyers practicing before federal courts in monitoring and reporting ethical violations.

We note also, as a practical matter, that in circumstances such as those present here, it is highly unlikely that any of the parties other than the insurers or their attorneys would challenge the application for retention of Gilbert. Congoleum, Gilbert, Perry Weitz and Joseph Rice worked together to negotiate the terms of the pre-packaged plan and all were deeply committed in having it approved. Moreover, we are aware that the standard set out in *Travelers* is a jurisprudential and not a strict statutory requirement for standing. We are persuaded that, in the circumstances here, the insurers and their attorneys have standing to present this appeal.

V.

Having concluded that standing has been established, we turn to the Rules of Professional Conduct and the standards set by the Bankruptcy Code.

A.

The District Court’s local rules provide that the rules of American Bar Association, as revised by the New Jersey Supreme Court, apply to attorneys practicing before the court “subject to such modifications as may be required or permitted by federal statute, regulation, court rule or decision of law.” Local Rule 103.1 (D. N.J.). In the absence of a “definitive state court decision interpreting the rules as promulgated by the [New Jersey] Supreme Court, the federal court will

In *International Business Machines Corp. v. Levin*, 579 F.2d 271, 279 n.2 (3d Cir. 1978), we noted that the “conduct of practitioners before the federal courts must be governed by the rules of those courts rather than those of the state courts.” However, in *United States v. Miller*, 624 F.2d 1198 (3d Cir. 1980), we approved the district court’s reliance on an opinion of the Supreme Court of New Jersey in applying the local rules on professional conduct. We observed that incorporation of state law in this field serves to avoid “detriment to the public’s confidence in the integrity of the bar that might result from courts in the same state enforcing different ethical norms.” *Id.* at 1200.

State precedents as to professional responsibility should be consulted when they are compatible with federal law and policy and do not “balkanize federal law.” *Grievance Comm. for Southern District of New York v. Simels*, 48 F.3d 640, 645 (2d Cir. 1995); see also *Resolution Trust Corp. v. Bright*, 6 F.3d 336, 341 (5th Cir. 1993). Bankruptcy professionals are required to examine their relationship not only based on the two-party litigation model, but also one guided by “a stricter, fiduciary standard.” 1 *Collier on Bankruptcy* (15th ed.) P 8.01[1].

Rule 1.7 of the New Jersey Rules of Professional Conduct, like Rule 1.7 of the ABA’s Model Rules of Professional Conduct, provides that, a lawyer shall not represent a client if there is a “concurrent conflict of interest,” a situation where either:

1. the representation of one client will be directly adverse to another client; or
2. there is a significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client, a former client, or a third person or by a personal interest of the lawyer.

*NJ RPC 1.7(a)*\(^{12}\) Notwithstanding the existence of a concurrent conflict of interest, a lawyer may undertake the representation if:

1. each affected client gives informed consent, confirmed in writing, after full disclosure and consultation…when the lawyer represents multiple clients in a single matter, the consultation shall include an

\(^{12}\) Rule 1.7 of the New Jersey Rules of Professional Conduct was revised in November 2003 and the new rule became effective on Jan. 1, 2004. The previous version of Rule 1.7 did not address situations where a lawyer’s responsibilities to former clients impaired the current representation and it did not use the “significant risk language”; instead it mentioned situations where the representation of a client “may be materially limited” by a lawyer’s other responsibilities. These changes do not affect our disposition of the case because Gilbert would have been acting under a concurrent conflict under either version of the rule.
explanation of the common representation and the advantages and risks involved;

(2) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(3) the representation is not prohibited by law; and

(4) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal.

NJ RPC 1.7(b).

Comments to the ABA version of this rule explain the policies underlying a rule against concurrent conflicts of interest. Absent consent, a lawyer may not act as an advocate in one matter against a person the lawyer represents in some other matter, because a conflict that materially limits a lawyer’s representation of her client, even absent direct adversity may hinder a lawyer’s ability to “recommend or advocate all possible positions” for her clients. Annotated Model Rules of Professional Conduct 109 (5th ed.).

As the New Jersey rule specifies, the lawyer’s own interests should not be permitted to have an adverse effect on, or otherwise materially limit, the representation of a client. A lawyer cannot allow a related business interest to affect his representation, for example, by referring clients to an enterprise in which the lawyer has an identified financial interest. See id.

In addition to the standards established by professional ethics, attorneys retained in bankruptcy proceedings are also required to meet the restrictions imposed by §327 of the Bankruptcy Code. Subsection (a) restricts retention of lawyers and other professionals to those

13 §327(a) states:

“Except as otherwise provided in this section, the trustee, with the court’s approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee’s duties under this title.”

11 U.S.C.A. §327(a). §327(e) addresses professionals employed for a “specified special purpose” and provides that

“The trustee, with the court’s approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.”

11 U.S.C.A. §327(e).

(Continued…)
who do not hold or represent an interest adverse to the estate and are disinterested. Subsection (e) permits employment of an attorney “for a specified special purpose,” so long as the attorney does not hold or represent “any interest adverse to the debtor or to the estate with respect to the matter” on which he is to be employed. The “special purpose” must be unrelated to the reorganization and must be explicitly described in the application. 3 Collier on Bankruptcy (15th ed.) P 327.04[9][d].

To put the matter in focus we will review Gilbert’s activities in chronological order. In September 2002, when it had existing co-counsel agreements with Weitz in several asbestos matters, Gilbert represented Congoleum in settlement negotiations with Weitz to resolve the claims of two of its own clients.14 Cook and Arsenault, whose mesothelioma claims were then in trial. Congoleum settled the cases for cash, plus a secured claim against funds that Congoleum hoped to recover from its excess insurers.15 In November 2002, Gilbert became co-counsel with Weitz in two other asbestos bankruptcy cases.

In February 2003, Congoleum retained Gilbert for the purpose of negotiating the pre-packaged chapter 11 reorganization. The retainer called for negotiations with “key asbestos bodily injury claimants’ counsel” as well as achieving the “terms of a ‘pre-packaged’ plan of reorganization…reviewing and commenting on the plan of reorganization…[and] assisting or consulting with Congoleum and its bankruptcy counsel on a strategy for confirmation of the pre-packaged plan.”

For most of 2003, Gilbert, Weitz and Rice worked on the terms of an agreement to settle Congoleum’s current asbestos related injury claims. The settlement agreement they ultimately drafted provided for screening of each participating claimant by Kinesis, a process that was in effect during the pre-petition period. At the same time, Gilbert was assisting the Dughi firm in the coverage litigation in the New Jersey state court.

Weitz represented many individuals who presented claims against Congoleum and who were screened by Kinesis and who were also clients of Gilbert as co-counsel. Before the insurers’ appeal reached the District Court, Gilbert produced in the New Jersey coverage action a list of claimants that it represented as co-counsel with Weitz. This list contains the names of approximately 15,000 individuals; the insurers estimated 10,000 of those individuals have claims

§327 applies to a debtor in possession as well as a trustee. United States Trustee v. Price Waterhouse, 19 F.3d 138 (3d Cir. 1994).

14 It appears that Gilbert acted as co-counsel with Weitz for these two individuals in their claims against another bankrupt asbestos company.

15 We note a striking disparity between the combined settlement of $16 million, which included fully secured assignments of insurance proceeds Messrs. Cook and Arseneault received, and the partially unsecured $100,000 settlement that others with mesothelioma claims would receive under the settlement agreement’s disease matrix.
against Congoleum. Neither Gilbert nor Congoleum have denied that there is an overlap of claimants.\(^\text{16}\)

In at least three other asbestos claimant cases, Gilbert and Weitz had agreed to charge the individuals they jointly represented a 10 percent contingency fee “on any and all insurance proceeds recovered [by the claimant] in connection with their claims against [the asbestos defendant] and its insurers.” The insurers here assert that that same fee arrangement is present in cases against Congoleum. Gilbert has not denied that assertion despite demands that it disclose the details of its fee sharing arrangements with Weitz. Thus Gilbert represented Congoleum and actively participated in the claimants’ settlement negotiations while simultaneously representing some of those claimants, albeit assertedly only in insurance matters.

In negotiating the settlement agreement and plan terms with Weitz and Rice pre-petition, Gilbert, as counsel for Congoleum, had a duty to limit the company’s responsibility on such key features as the disease matrix, exposure to asbestos from Congoleum products, if any, and the extent of actual injury. Although the settlement agreement required the claimants to release Congoleum, Gilbert admitted in the coverage action in state court that the release was a limited one and applied only if proceeds were recovered from the insurance companies. If that attempt failed, then Congoleum would be liable to the individual claimants for the amount of the settlements, thus pitting Congoleum against the individual claimants Gilbert represents as co-counsel with Weitz.

Congoleum’s interests called for a reduction in the number of claims approved that would likely be included in a settlement package presented to the insurers. The insurers cited major deficiencies in the validity of some claims approved by Kenesis. To the extent that the claims were not valid, it was Gilbert’s responsibility in representing Congoleum to see that they were rejected, even though it would be adverse to Gilbert’s interests if those claims were pursued individually or were excluded from a “package” offered to the insurers in settlement. This was not a potential, but an actual conflict.

To legitimize the alleged conflicts, Gilbert relies on waivers both from Congoleum and clients the firm represented as co-counsel with Weitz. However, Gilbert did not contact the claimants; instead it relied upon Weitz to secure those waivers.

As discussed above, in several earlier asbestos bankruptcy proceedings, Weitz executed engagement letters for Gilbert’s work as co-counsel. In those agreements, Weitz waived “all present and future conflicts of interest on behalf of” the individual clients the firms jointly represented and agreed to advise the clients of the information contained in the engagement letters including Gilbert’s disclosure of its representation of tort defendants. Gilbert has not

\(^{16}\) In a deposition in the New Jersey coverage action, Scott Gilbert, a partner in Gilbert, was asked if any of the claimants he represented as co-counsel with Weitz in the Robert A. Keasbey case were also suing Congoleum. Scott Gilbert replied that he was unsure how many claimants overlapped and had never attempted to determine if there was an overlap. In subsequent deposition testimony he would only “assume” that Gilbert represented clients in other bankruptcies that had claims against Congoleum, including Messrs. Cooke and Arsenault.
disclosed an engagement letter with Weitz for claimants in the Congoleum case, although it has not denied that one exists.

The record does not establish that Weitz had the authority to issue waivers on behalf of the thousands of individual claimants it represented. In addition, the record does not include the information, if any, that Weitz furnished to the individuals nor does it indicate whether they were given the opportunity to object to Gilbert’s representation.17

Although concurrent conflicts may be waived by clients under the New Jersey and ABA Rules of Professional Conduct, the effect of a waiver, particularly a prospective waiver, depends upon whether the clients have given truly informed consent. Given the complexities of the bankruptcy proceeding and the “many hats” worn by Gilbert throughout the pre- and post-petition process, we cannot conclude that the purported waivers Gilbert received from Weitz “on behalf of” the individual clients constituted informed, prospective consent. See Baldasarre v. Butler, 132 N.J. 278, 625 A.2d 458 (N.J. 1993) (concluding that informed consent was not sufficient in a complex commercial real estate transaction); In re Matter of Edward J. Dolan, 76 N.J. 1, 384 A.2d 1076, 1082 (N.J. 1978) (“This Court will not tolerate consents which are less than knowing, intelligent and voluntary.”); In re Lanza, 65 N.J. 347, 322 A.2d 445 (N.J. 1974) (concluding that attorney should have first explained...all the facts and indicated in specific detail all of the areas of potential conflict that foreseeably might arise.”).

We conclude that Gilbert did not receive effective waivers from the claimants it represented and, therefore, acted in violation of the Rules of Professional Conduct.

B.

In addition to failing to review the waiver problem, the bankruptcy judge relied on an unrealistic view that the insurance interests of the claimants and Congoleum were so closely aligned and so narrowly defined that there was no actual conflict of interest. This error was the result, to a great extent, of the court’s refusal to consider evidence about Gilbert’s activities in negotiating and preparing the plan before its filing. Those pre-petition activities were clearly separate from seeking a recovery from insurance companies after the claims were liquidated or from attempting to negotiate settlements with the insurers.18

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17 In a subsequent proceeding, the insurers challenged Rice & Weitz’s failure to disclose any type of co-counsel, consultant or fee sharing relationships as required by Bankruptcy Rule 2019. The bankruptcy judge directed Weitz, Rice and others to comply and commented that many of the creditors “have never seen a copy of the disclosure statement and, for all the court knows, have absolutely no idea how their claim will be treated under the plan.” Baron & Budd, P.C. v. Unsecured Asbestos Claimants Comm. [Congoleum], 321 B.R. 147, 2005 WL 435207 (D. N.J. 2005).

18 On May 13, 2005, the state judge in the New Jersey coverage action heard oral argument on a motion to disqualify Gilbert as counsel for Congoleum in that action. The court concluded it would “reluctantly deny the insurance companies’ motion to disqualify GHR as Congoleum’s attorney.” The judge stated that he might have reached a different result if he had received the motion to disqualify earlier in the proceedings. The court also noted, in support of its decision not to grant the motion to disqualify, that the Bankruptcy and District Courts in this proceeding had previously denied similar motions as to Gilbert’s alleged conflicts of interest.
The application presented to the bankruptcy court recited that Gilbert would be “primarily responsible for strategic advice on insurance issues, including but not limited to insurance-related settlement negotiations and the representation of the Debtors with respect to insurance issues arising in the context of the chapter 11 cases.” However, the application also stated that Gilbert’s representation had encompassed the negotiations of the plan and pre-petition settlement of asbestos claims. The application indicated that services to be provided post-petition included “advising and assisting the debtors with respect to insurance-related issues in connection with the formulation, negotiation, and confirmation of a plan of reorganization.”

Although the bankruptcy court relied on the narrow role Gilbert was to have in the reorganization process, the judge did not inquire about the broad scope of Gilbert’s activities in negotiating the plan and the settlement agreement. Nor did the court question Gilbert’s role post-petition, as described in Congoleum’s application, in “advising and assisting [Congoleum] with respect to insurance-related issues in connection with the formulation, negotiation and confirmation of a plan of reorganization.”

Gilbert, in fact, continues to participate actively in formulating and revising the plan. There have been changes and amendments, at least four of them, to the text of the original plan thus far and Gilbert has been involved in that process. A fifth version of the plan is set for consideration some months hence.

In the usual situation, when counsel is retained to recover insurance proceeds, the underlying claim has been reduced to a judgment or settled for a specific amount. The retention of special counsel to act solely as appellate lawyer in such circumstances is an example of the intent of §327(e). But here the claims have not been liquidated—the plan has not yet been approved and only that ruling will confirm the specific allocation of damages. Until that occurs, action against the insurers is premature. Gilbert has attempted to draw a sharp demarcation between its insurance advice and other tasks it undertook. Its efforts, however, might be likened to attempts at using a scalpel to carve a bowl of soup.

Gilbert’s retention is far too expansive an assignment to be appropriate for an appointment under §327(e). The application more properly falls under the ambit of §327(a) which allows employment of professionals to assist generally in the administration of the estate. That subsection, however, prohibits appointments of individuals or entities who hold or represent an interest adverse to the estate and are not “disinterested.”

In Marvel Entertainment Group, 140 F.3d 463 (3d Cir. 1998), we held that disqualification could be imposed where an actual conflict of interest was present or, within the discretion of the court, where a potential conflict of interest existed. The presence of the appearance of impropriety standing alone is not a sufficient ground for disqualification, id. at 477, but there is more than that here. See also In re BH&P, Inc., 949 F.2d 1300, 1313 (3d Cir. 1991) (“In some circumstances, the potential for conflict and the appearance of conflict may, without more, justify removal…[of a trustee].”); In re Martin, 817 F.2d 175, 180-81 (1st Cir. 1987) (concluding that §327 addresses the appearance of impropriety, “irrespective of the integrity of person or firm under consideration.”); 3 Collier on Bankruptcy (15th ed.) §327.04
Appendix 17(a) - In re Congoleum Corp.

[5][a] (noting that the appearance of impropriety may, when combined with a potential conflict, be sufficient for disqualification).

Our discussion of the Rules of Professional Conduct demonstrates that Gilbert also cannot meet the Bankruptcy Code’s requirement of disinterestness contained in §327(a). Its status as co-counsel with Weitz and its ownership interest in Kenesis represent factors which prevent Gilbert from being completely loyal to Congoleum’s interests. We note also in this respect that waivers under §327(a) are ordinarily not effective. See In re Granite Partners, L.P., 219 B.R. 22, 34 (Bankr. S.D.N.Y. 1998); Collier on Bankruptcy P 328.05[3] (15th ed.).

We conclude that Gilbert’s employment in this case was contrary to §327 of the Bankruptcy Code.

We do not approve of a bankruptcy court applying less than careful scrutiny to pre-petition procedures in pre-packaged plans. The parties here seek the court’s *imprimatur* of a reorganization that will free the debtor of all current and future asbestos liability. The legitimacy of such a transaction is dependent on the stature of the court. See also S. Elizabeth Gibson, Fed. Judicial Ctr., Judicial Management of Mass Tort Bankruptcy Cases 122 (2005). (“A judge presented with a prepackaged mass tort plan needs to be fully informed about the circumstances surrounding the prepetition negotiations in order to determine whether the process has been tainted by conflicts of interest or self-interested actions by the participants.”).

In a pre-packaged setting, most of the work on a plan of reorganization that would occur in a “traditional bankruptcy” happens before the debtor files its petition. For a court to approve a pre-packaged plan whose preparation was tainted with overreach, for example, would be a perversion of the bankruptcy process.

Pre-packaged plans offer a means of expediting the bankruptcy process by doing most of the work in advance of filing. That efficiency, however, must not be obtained at the price of diminishing the integrity of the process. In this case, it was not a proper exercise of the bankruptcy court’s discretion to fail to consider and appraise the conduct of the parties and counsel pre-petition.

We observe also that the bankruptcy court has an obligation to prevent unnecessary expenditures in the administration of an estate. See In re Busy Beaver Bldg. Ctrs., 19 F.3d 833 (3d Cir. 1994) (holding that the bankruptcy court has authority to examine counsel fees *sua sponte*). Even if it be assumed that Gilbert’s representation of Congoleum post-petition was exclusively related to its forthcoming disputes with the insurers, it is not clear on this record why it was necessary to appoint an additional firm to handle insurance issues. The Dughi firm had represented Congoleum for more than ten years in insurance matters and had been actively

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19 In Baron & Budd, P.C. v. Unsecured Asbestos Claimants Committee [Congoleum], 321 B.R. 147 n.17, 2005 WL 435207 (D. N.J. 2005), a proceeding in the Congoleum case subsequent to this one, both courts agreed that pre-petition relationships were relevant. “The totality of the facts before the bankruptcy court suggest the opportunity for abuse of fee sharing relationships, involving attorneys in connection with the pre-petition process, to the end of conferring preferential security interests on appellant’s clients.”
engaged in the state court coverage action since 2001. The record fails to reveal what special competence in the insurance field Gilbert would provide in addition to that of the Dughi firm.

The flood of asbestos litigation has been a serious problem for the courts of this country because the large number of claims are not easily adaptable to traditional common law procedures. See Amchem Products v. Windsor, 521 U.S. 591, 138 L. Ed. 2d 689, 117 S. Ct. 2231 (1997); Combustion Engineering, 391 F.3d at 200. Congress has provided for the use of a trust and channeling injunction as a possible solution, but it appears that the proposals for implementation of an administrative system somewhat similar to that used in black lung claims are more promising.

As this case demonstrates, leaving the procedures for allocation of resources predominantly in the hands of private, conflicting interests has led to problems of fair and equal resolution. The need for counsel with undivided loyalties is more pressing in cases of this nature than in more familiar conventional litigation. Correspondingly, the level of court supervision must be of a high order.

Many of the issues are similar to those that arise in class actions for personal injuries. In re Cmty. Bank of N. Va. & Guar. Nat’l Bank of Tallahassee Second Mortg. Loan Litig., 418 F.3d 277 (3d Cir. 2005), we commented that “in class actions, particularly settlement-only suits, the district court has a duty ‘to protect the members of the class…from lawyers for the class who may, in derogation of their professional and fiduciary obligations, place their pecuniary self-interest ahead of that of the class.’” Id. at 318 (quoting Reynolds v. Beneficial Nat’l Bank, 288 F.3d 277, 279 (7th Cir. 2002)). We need make no finding that this has occurred in the case before us, but we caution that here, as in situations of settlement-only class litigation, “careful and comprehensive scrutiny is required.”

We recognize that ordinarily a remand to the District and Bankruptcy courts would be in order for further findings and appropriate action. However, here the record contains sufficient evidence that we may expedite the procedures. Therefore, we will reverse the order approving the retention of the Gilbert firm and remand to the District Court for further proceedings consistent with this Opinion.
Chapter 18
BAD WORDS

Chapter 11 debtors typically remain in control of their estates as debtor-in-possession, often seeing their case to completion through confirmation of a chapter 11 plan. But it doesn’t always go this way. The Bankruptcy Code provides that the court may:

- appoint a trustee;
- appoint an examiner;
- convert the case to chapter 7;
- dismiss;
- end exclusivity.

A different topic, but still a “bad word” for many troubled companies, is “involuntary bankruptcy.” We cover this topic in this chapter as well.

Chapter 11 Trustees

The Bankruptcy Code says the court may order the appointment of a trustee “for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor …,” or “if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate …,” or if grounds exist to convert or dismiss the case under §1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate. See §1104(a).

The UST must move for appointment of a trustee if there are “reasonable grounds to suspect that current members of the governing body of the debtor, the debtor’s chief executive or chief financial officer, or members of the governing body who selected the debtor’s chief executive or chief financial officer, participated in actual fraud, dishonesty or criminal conduct in the management of the debtor or the debtor’s public financial reporting.”

Appointment of a trustee is mandatory in chapter 7, 12, and 13 cases. However, the appointment of a trustee in a chapter 11 case is an extraordinary remedy. A request for the appointment of a trustee must overcome the presumption that the debtor will continue to control its business. The basis for the strong presumption against appointing a trustee is twofold. First, there is often no need for one—DIPs have a fiduciary duty to act in the best interest of creditors and other stakeholders, are typically motivated to maximize value, and usually don’t engage in significant wrongdoing or malfeasance. Second, the DIP is usually familiar with the business it had already been managing pre-petition, often making it the best party to conduct operations during the reorganization. (It is worth noting that in many other countries there is not a presumption that current management will continue to run the business in bankruptcy, perhaps borne of a desire to get rid of the managers who ran the company into bankruptcy.)
The burden is on the moving party to demonstrate by clear and convincing evidence that appointment of a chapter 11 trustee is appropriate. Although the second part of the standard (best interest of creditors and other stakeholders) would seem somewhat easier to satisfy, as a practical matter it is very difficult to get a trustee appointed without showing some level of post-petition incompetence and/or malfeasance by the debtor’s management.

Aside from the presumption in favor of current management and the high standard for appointment of a trustee, another reason why you don’t see many chapter 11 trustees is that where you really do need a trustee—such as where management has destroyed the business—the case may convert to chapter 7 first.

If a chapter 11 trustee is appointed, he/she basically has the same obligations as the DIP, including running the business and filing a plan of reorganization. See §1106. The trustee is typically appointed by the UST, usually after consultation with major creditors. There is, however, a provision that permits election of the trustee. See §1104(b). There is a similar provision for chapter 7 trustees, although it is not commonly utilized under either chapter.

Even without forcing the appointment of a trustee, creditors may get control of the debtor by forcing a change of management. Indeed, in a great many public-company chapter 11s (including some of the most notorious), this is exactly what happens: creditors force out the old management before the chapter 11 begins, and so the nominal “DIP” is someone in whom creditors have faith, sent in to clean up the mess that others left behind.

Chapter 11 Examiners

The Bankruptcy Code states that a court may appoint an examiner after a party in interest or UST requests the appointment. One reported decision has indicated that a bankruptcy court has authority to appoint an examiner *sua sponte*.

An examiner is to be appointed if the court determines that such appointment is in the interests of creditors and other stakeholders or if the debtor’s unsecured non-insider debts exceed $5 million. See §1104(c)(2).

Bankruptcy Code §1104(c) provides that the court may order the appointment of an examiner “to conduct…an investigation of the debtor.” In fact, courts have stretched the language of this rule a bit: several courts have used “examiners” in complicated cases to try to leverage out-of-court settlements. In other cases, examiners have been appointed to evaluate causes of action the estate may have. Cases with examiners are relatively uncommon, but it is sometimes a viable alternative to a trustee. In a complicated case where the court is reluctant to impose the costs and inconvenience of a trustee—but where the judge wants more comfort than he gets from the DIP—an examiner may be the ticket.

Conversion and Dismissal

Bankruptcy Code §1112 authorizes conversion or dismissal. On the motion of a party in interest, the court may order conversion or dismissal for any of sixteen reasons itemized in Bankruptcy Code §1112(b). In fact, §1112(b) is structured to appear to favor conversion or
dismissal on request of a party in interest “absent unusual circumstances specifically identified by the court that establish that the requested conversion or dismissal is not in the best interest of the creditors and the estate.” These include:

- “substantial or continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation”;
- “gross mismanagement of the estate”;
- “inability to effectuate a plan”;
- “inability to effectuate substantial consummation of a confirmed plan”;
- “unreasonable delay by the debtor that is prejudicial to creditors.”

Translated, we think this means: “your honor, this case is going nowhere, and it is time to put a bullet through the poor beast.” If nothing more can be accomplished in chapter 11—because of the debtor and its circumstances and/or because of the limits of what chapter 11 cases achieve—then dismissal may be warranted.

The hearing on the motion must be within 30 days of its filing and it must be decided within 15 days of the hearing absent the movant’s consent or compelling circumstances. Where the grounds exist, the judge has the choice of dismissal or conversion. So which one should you ask for? If you go for conversion, you are still stuck with the bankruptcy process—a chapter 7 trustee, notice to creditors, all that sort of thing. On the other hand, you have the benefit of judicial supervision and you preserve avoidance actions that may bring money into the estate. If you go for dismissal, you get shed of all that encumbrance—but so does the debtor. So you save the costs and inconvenience of bankruptcy, but you also lose the protections. There isn’t any general rule here. The point is that in each case, you are going to have to weigh the costs and benefits of staying in versus getting out.

**Exclusivity**

Underlying all these issues is the question of who may propose a chapter 11 plan. Bankruptcy Code §1121(b) provides that only the DIP may propose a plan in the first 120 days of a chapter 11 case. This period can be extended but not beyond 18 months after the petition date. In a corporate case, “DIP” means the managers of the debtor corporation, controlled, ultimately by the shareholders. We think this rule is a linchpin of chapter 11, often underappreciated—it allows old equity owners to use chapter 11 as a “second bite at the apple,” to give them one last chance before they lose control to the creditors.

The immediate relevance is that the rule goes away if conversion, dismissal, or the appointment of a trustee occurs. So, this critical power of “debtor exclusivity”—a linchpin of the chapter 11 case—vanishes if any of these events comes to pass.
Involuntary Bankruptcy

Now, a word about involuntary bankruptcy. There is an irony here. Five hundred years ago when bankruptcy was young, the idea of “voluntary bankruptcy” was pretty much of an oxymoron: bankruptcy was a creditor’s remedy and a debtor wouldn’t volunteer for it. Bankruptcy began to look attractive to the debtor only after the introduction of the first primitive discharge rule in 1705. And indeed, it wasn’t until after World War II that we observe large numbers of debtors voluntarily filing for bankruptcy with the discharge in view.

The Bankruptcy Code still permits creditors to begin an involuntary case (see §303). Only a very small number of involuntary cases show up on the docket—and if anything, we suspect this tiny number is larger than it should be. We think that involuntary bankruptcy, in keeping with its antiquarian roots, is pretty much like a muzzle-loading weapon: occasionally lethal, and as likely as not to blow up in your face.

The first problem is the threshold: it’s not easy to start an involuntary case. You need three or more creditors holding claims that “aggregate at least $12,300 more than the value of any lien.” The Bankruptcy Code does say that if the debtor has fewer than 12 creditors in total, you can get away with just one petitioner—but most debtors have more than 12 creditors, so in the usual case you will need 3 petitioners. This means that before you begin, you have to find at least two other creditors just as motivated as you are. An involuntary case cannot be commenced against a nonprofit business.

In a voluntary case, the filing of the petition begins the bankruptcy. In an involuntary, the filing just begins a contested matter. That is, if the debtor challenges the petition, then the creditor has to prove either one of these bankruptcy predicates:

- the debtor is generally not paying such debtor’s debts as such debts become due; or

- within 120 days before the date of the filing of the petition, “a custodian…was appointed or took possession.” Translating, this means that if the debtor makes an assignment for the benefit of creditors at state law, then you can put him into an involuntary bankruptcy.

Because of the potency of involuntary bankruptcy, the Bankruptcy Code affords protection against creditors who seek to improperly invoke its power. For example, §303(i) sets out remedies in cases in which an involuntary petition is dismissed other than on consent of all petitioners and the alleged debtor.

Until the court enters an “order for relief,” finding that the grounds for involuntary bankruptcy have been satisfied, the “alleged debtor” is in what’s known as the “gap period.” During this period, the debtor is allowed to operate its business and use, sell or lease its assets as if it were not in bankruptcy. If there is a risk of loss to the estate during this period, the court may appoint a trustee during the gap period.
So filing an involuntary is chancy and potentially hazardous. But even ignoring chance and hazard, there is a more fundamental question: do you need it? Consider the classic case: your client is one of many creditors of the debtor and is morally certain that the debtor is dissipating assets.

On the one hand, there are nonbankruptcy remedies available which may enable you to collect your debt and prevent dissipation of assets. These may be quicker and cheaper than bankruptcy and may enable you to collect amounts owed in full without sharing with other creditors.

On the other hand, once you file the involuntary, you’ve bought yourself a whole new set of enemies. The involuntary is a bell you can’t unring: once you file, you can’t dismiss without giving notice to all other creditors. If you win the involuntary adjudication, there will be a trustee, who may or may not act as your ally, and there will be lots of other creditors who will want to share *pro rata* anything that is available—and some of whom may have a statutory priority in bankruptcy. Further, courts are not pre-disposed to grant motions for relief from stay brought by involuntary petitioning creditors. The attitude appears to be, “you started it, live with it.”

The cases where involuntary bankruptcy is most worthy of consideration are those where (1) the debtor is mishandling or dissipating assets and there does not appear to be any quick and effective way to stop it other than the court supervision that comes with bankruptcy or (2) cases where a significant transfer has been made which would be avoidable if the transferor were put into bankruptcy (the lookback period—90 days in the case of non-insider preferences, for example, can be locked in by filing before the transfer is immunized from avoidance by growing “old and cold.”) So there are cases where involuntary bankruptcy can be effective, but it is a weapon of last resort, and you’d better think it through carefully before you take your client’s bad situation and make it worse.
APPENDIX 18(a)  
IN RE TRADEX CORPORATION

This edited order lays out the First Circuit law regarding appointment of a trustee and illustrates its application.


The president and sole shareholder of the debtor in possession seeks reversal, on behalf of the debtor, of the bankruptcy court’s appointment of a trustee to take possession of Tradex Corporation (“Tradex” or “the debtor”) as part of voluntary chapter 11 bankruptcy proceedings. For the reasons stated below, I affirm the bankruptcy court’s decision.

I. Standard of Review

When a District Court reviews a decision of the bankruptcy court, findings of fact are upset only if clearly erroneous, but questions of law are subject to de novo evaluation. See Fed. R. Bankr. P. 8013; Sir Speedy, Inc. v. Morse, 256 B.R. 657, 658 (D. Mass. 2000) (citing In re Winthrop Old Farm Nurseries, Inc., 50 F.3d 72, 73 (1st Cir. 1995)). A discretionary decision of the bankruptcy court is overturned only when there has been abuse of that discretion. Neal Mitchell Assoc. v. Braunstein, 227 B.R. 1, 6 (1st Cir. 1998).

In order to give effect to those precepts in this case, however, I must determine the standards, as matters of law and fact, for the appointment of a bankruptcy trustee, as well as what, if any, discretion is afforded to a bankruptcy judge in making such a determination.

II. Background

Tradex is a company that manages and leases a plastics manufacturing facility in Lunenberg, Massachusetts. Charles Gitto, Jr. is the president and sole shareholder of Tradex. On Feb. 16, 2005, he signed a voluntary petition for relief under Chapter 11 of the bankruptcy code and became a debtor-in-possession. That petition did not conform with 11 U.S.C. §521, which requires inclusion of a list of creditors, schedules of assets and liabilities, or a statement of financial affairs. The day it was filed, the bankruptcy court ordered Tradex to file the required information. Tradex filed a motion a week later requesting extension of the deadline to file the financial information, a motion the court denied. On March 3, Tradex filed a §521 statement.

On March 15, 2005, a meeting of creditors was held pursuant to §341 of the bankruptcy code at the Worcester, Massachusetts office of the United States Trustee. Mr. Gitto, asserting his Fifth Amendment privilege, did not attend. Instead, his wife, Krista Gitto, the office manager of the debtor, appeared on Tradex’s behalf. Aspects of her testimony, along with certain prepetition transactions of Tradex and an ongoing grand jury investigation into fraud allegations relating, inter alia, to Mr. Gitto and Tradex, caused concern on the part of the United States Trustee, who on April 1, 2005, filed a motion with the bankruptcy court to appoint a chapter 11 trustee to replace Mr. Gitto. Before the hearing on the motion, the United States Trustee received
a copy of the debtor’s 2003 tax return, which heightened the Trustee’s concerns. The debtor objected to the motion to appoint a trustee on April 6, 2005, arguing that the Trustee had not met her burden of establishing the need for such an appointment under §1104(a)(1) or (2).

On April 7, 2005, the bankruptcy court held a hearing on the motion and relying upon both §1104(a)(1) and (2) with a brief order granted it from the bench. Five days later, the Trustee requested that Attorney Ellen Carpenter be appointed as trustee, a request the court granted on April 13, 2005. On April 18, 2005, the debtor sought reconsideration of the court’s decision to appoint a trustee. The court denied the debtor’s request the following day, finding that the motion failed to meet the requirements of Rule 59(e) and that the “new information” regarding a loan was “insufficient to alter the previous decision of the Court” which “was based on several factors, including the principal’s past dealings with the debtor.”

Three days later Tradex appealed that decision to this court and filed a motion with the bankruptcy court requesting that appointment of the trustee be stayed pending appeal. n2. The bankruptcy court denied that request on April 25, 2005. On April 28, 2005, Tradex requested that I issue a stay pending appeal. I denied that request on May 2, 2005, and put the appeal on an expedited briefing and hearing schedule.

While I was satisfied by the conclusion of the hearing that the Bankruptcy Court’s decision to appoint the Trustee was plainly well founded, I found the case law unhelpful in explaining the relevant standards. Consequently, I have taken some time to attempt to draft in this opinion a satisfactory basis for my decision to affirm the Bankruptcy Court.

III. Discussion

A. Section 1104(a)

The bankruptcy code empowers a bankruptcy court to appoint a trustee in a chapter 11 proceeding under certain circumstances. Section 1104 of the Code provides:

(1) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee —

(A) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or

(B) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.


Once the party seeking a trustee meets its burden, the court is seemingly required to—in the words of the statute, it “shall,” 11 U.S.C. §1104(a)—appoint a trustee. *Official Comm. of Asbestos Claimants v. G-I Holdings, Inc.* (*In re G-I Holdings, Inc.*), 385 F.3d 313, 318 (3d Cir. 2004); see *In re Oklahoma Refining Co.*, 838 F.2d 1133, 1136 (10th Cir. 1988) (“Once the court has found that cause exists under §1104, it has no discretion but must appoint a trustee.”); *Colorado-Ute*, 120 B.R. at 174; *St. Louis Globe-Democrat*, 63 B.R. at 138 (“Where clear and convincing evidence is offered to prove that cause’ exists…then the Court has no discretion but must appoint a trustee.”). *Cf. Petit*, 182 B.R. at 69 (“Indeed, some courts have read this section of the statute as mandating the appointment [sic] a trustee when there are findings of the circumstances described in subsection (a)(1).”).

B. Standard of Proof

Although it is undisputed that the party seeking appointment of a trustee bears the burden of persuasion, a question remains regarding the standard of proof necessary to meet the burden.

The First Circuit has not addressed the approach a court should take in determining whether to appoint a trustee. The First Circuit Bankruptcy Appellate Panel in *Garland* did comment in an opinion by now Circuit Judge Cyr that:

the appropriateness of the decision to appoint a reorganization trustee under Bankruptcy Code §§1104 and 15104 turns upon whether there was
a sufficient showing of cause, including incompetence or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or, in the alternative, a showing that the appointment would be in the best interests of the creditors and the estate.

Garland, 6 B.R. at 460.

Just a few weeks prior to the Garland decision, Judge Gabriel described §1104 as “a compromise providing for a flexible standard for the appointment of a trustee.” In re Eichorn, 5 B.R. 755, 757 (Bankr. D. Mass. 1980). Although there is a presumption that a debtor will remain in possession, §1104(a)(1) “reflects criteria which mandate the appointment of a trustee for cause.” Id. “Under this subsection the court’s discretionary powers are circumscribed and are limited to a judicial determination of whether cause,’ as defined, exists.” Id. But as with the BAP in Garland, Judge Gabriel did not delineate the standard of proof that must be applied when taking up subsection §1104(a)(1). Turning to subsection §1104(a)(2), he seemed to find the discretion of the bankruptcy court not nearly so circumscribed as with §1104(a)(1). Id. at 758 (“Congress…has given the Bankruptcy Court the flexibility under §1104, §1104 (a)(2), to allow the court to utilize its broad equity powers in determining whether the appointment of a trustee would be in the best interests of creditors, equity security holders and other interests of the estate.”).

Judge Pettine in In re Cumberland Invest. Corp., 133 B.R. 275 (D.R.I. 1991), appears to have employed a clearly erroneous standard in his review of the bankruptcy court’s factual findings regarding the need to appoint a chapter 11 trustee, concluding that the court’s “analysis of the voluminous evidence clearly supports his conclusion that the interest of the creditors required the appointment…” Id. at 280. And, in In re Crescent Beach Inn, Inc., 22 B.R. 155 (Bankr. D. Me. 1982)—contrary to the citation to it in In re Nautilus of New Mexico, Inc., 83 B.R. 784 (Bankr. D.N.M. 1988)—Judge Goodman, while placing the burden squarely on the moving party simply reviewed the evidence and found that he was “not persuaded” that “cause” existed. Id. at 159-60. The statutory provision was described in Crescent Beach Inn as “adopt[ing] a flexible standard for the appointment of trustees.” Id. at 160 (quoting In re Parr, 1 B.R. 453, 457 (Bankr. E.D.N.Y. 1979)). But neither Judge Pettine nor Judge Goodman expressly addressed the standard of proof being applied.

It appears courts in the First Circuit courts have not directly determined what evidentiary standard to apply when determining whether a “sufficient showing” has been made for purposes of §1104. However, as Judge Carter in Petit observed: “although the First Circuit has never held so directly, many courts require a showing of clear and convincing evidence supporting the motion prior to” appointment of a trustee. Petit, 182 B.R. at 69.

For example, the Third Circuit requires that the “party moving for appointment of a trustee…must prove the need for a trustee under either subsection [of §1104(a)] by clear and convincing evidence.” In re Marvel Entertainment Group, Inc., 140 F.3d 463, 471 (3d Cir. 1998); see G-I Holdings, 385 F.3d 313; Sharon Steel, 871 F.2d 1217. The Fifth Circuit has also
held that the moving party must meet its burden by “clear and convincing evidence.” In re Cajun Elec. Power Coop., Inc., 69 F.3d 746, 749 (5th Cir. 1995).

A number of bankruptcy courts have joined the Third and Fifth Circuits in applying a “clear and convincing” evidentiary standard. See, e.g., Sanders, 2000 Bankr. LEXIS 263, at *8, March 2, 2000) (“The appointment of a trustee is an extraordinary remedy that requires proof by clear and convincing evidence.”) (citing Bellevue Place, 171 B.R. at 623; Rivermeadows, 185 B.R. at 617 (“Because courts view a chapter 11 trustee appointment as an extraordinary step, the movant is generally required to present clear and convincing evidence of a trustee’s necessity.”); Colorado-Ute, 120 B.R. at 173; Nautilus, 83 B.R. at 788; In re William A. Smith Construction Co., 77 B.R. 124, 126 (Bankr. N.D. Ohio 1987).

Despite the fact that various courts have pronounced the appointment of a Trustee to be “extraordinary” and available only if the factual predicate is established by “clear and convincing” evidence, as a practical matter, whether the party has met its burden has consistently been left within the discretion of the bankruptcy court. The nature of that deference has been described in differing ways that further muddle the standards to be applied in reviewing a Trustee appointment decision.

Some courts, including the First Circuit Bankruptcy Appellate Panel, have said they must “accept the findings of the bankruptcy judge unless clearly erroneous.” Garland, 6 B.R. at 460. In Garland, this led the BAP to conclude that the “findings of fact are amply supported by the record, and the conclusions of law, freely reviewable on appeal, comport with the legislative prescriptions of sections 1104(a)...” Id. at 461 (citation omitted). Cf. In re Paolino, 60 B.R. 828, 829 (E.D.Pa. 1986) (“The factual determinations made by the bankruptcy judge must be accepted by this court, unless I am convinced that they are clearly erroneous. While I freely concede that reasonable minds might differ as to the extent and seriousness of the debtor’s derelictions, by no stretch of the imagination can the bankruptcy’s judge’s findings be deemed clearly erroneous.”).

By contrast, the Fifth Circuit, in Cajun Electric, has said that the “district court’s appointment of a trustee is reviewable only for abuse of discretion.” Cajun Electric, 69 F.3d at 749 (citing Sharon Steel, 871 F.3d at 1225-26; In re Dalkon Shield Claimants, 828 F.2d 239, 242 (4th Cir. 1987)); see also Bellevue Place, 171 B.R. at 623 (“A determination of whether cause exists to appoint a chapter 11 Trustee is within the discretion of the court and due consideration must be given to the various interests in the bankruptcy proceeding.”); see also G-I Holdings, 385 F.3d at 318. But see Deena Packaging, 29 B.R. at 706 (“Appointing a trustee for cause is not a discretionary function and necessarily includes a showing of fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case.”). n4. And, in Sharon Steel, the Third Circuit rejected a clearly erroneous standard, as embraced by the First Circuit Bankruptcy Appellate Panel in Garland, and adopted “an abuse of discretion standard.” Sharon Steel, 871 F.3d at 1225.

Despite the differing language used, there is widespread and consistent deference afforded to the bankruptcy court. See, e.g., Sharon Steel, 871 F.2d at 1226 (“While §1104(a) mandates appointment of a trustee when the bankruptcy court finds cause—seemingly requiring plenary review, a determination of cause...is within the discretion of the court.”) (quoting
Dalkon Shield Claimants, 828 F.2d at 242; Dalkon Shield Claimants, 828 F.2d at 241 (“The concepts of incompetence and dishonesty cover a wide spectrum of conduct and...the court has broad discretion in applying such concepts to show cause.”).

The bankruptcy court appears to enjoy even more sweeping discretion under subsection (a)(2). See In re Clinton Centrifuge, Inc., 85 B.R. 980, 983 (Bankr. E.D. Pa. 1988) (“Pursuant to §1104(a)(1), a court must appoint a trustee once cause is found; while §1104(a)(2) leaves the court with broad discretion to determine whether the interests of all constituencies would benefit from the appointment of a disinterested trustee.”) (citation omitted); see also Savino, 99 B.R. at 527 n.11. (“We would only note that the factors constituting a basis for appointing a trustee under §1104(a)(2) are amorphous, diverse, and necessarily involve a great deal of judicial discretion.”); see, e.g., Sharon Steel, 871 F.2d at 1226 (“§1104(a)(2) emphasizes the court’s discretion, allowing it to appoint a trustee when to do so would serve the parties’ and estate’s interests.”) William A. Smith, 77 B.R. at 126 (“The for cause’ standard of §1104(a)(1) is more circumscribed, whereas under §1104(a)(2) the Court has wider discretion to use its broad equity powers.”); Deena Packaging, 29 B.R. at 708(finding that, even in the absence of “cause,” it is “empowered under §1104(a)(2) to appoint a trustee to protect Flushing’s rights as a creditor”).

In applying that discretion, some courts have supplied a list of factors to consider. For example, the Colorado-Ute court advised as follows.

as to whether the appointment of a trustee is in the best interest of creditors pursuant to §1104(a)(2), the court should eschew rigid absolutes and look to the practical realities and necessities. The court should also consider the following four factors:

(i) the trustworthiness of the debtor;

(ii) the debtor in possession’s past and present performance and prospects for the debtor’s rehabilitation;

(iii) the confidence—or lack thereof—of the business community and of creditors in present management;

(iv) the benefits derived by the appointment of a trustee, balanced against the costs of appointment.

Colorado-Ute, 120 B.R. at 176 (citations omitted).

Having canvassed this case law, I have come to conclude that an appointment court need find the factual predicates—”cause” or the best interests of relevant parties—by only a preponderance of the evidence. Clear and convincing evidence is not required. Recognizing that this is contrary to the explicit statements of most other courts that have directly addressed the subject, I nevertheless believe it is consistent with the reasoning and approach undergirding the case law in this area. Indeed, after describing the burden as “clear and convincing” and citing the extraordinariness of appointing a trustee, courts generally take up the question as one falling with
the discretion of the bankruptcy courts, to which they defer, and do so in a way that directly or indirectly hollows out the “clear and convincing” standard cited.

More general Supreme Court reasoning in the bankruptcy realm suggests that the reflexive endorsement of a demanding “clear and convincing” evidentiary burden regarding trustee appointment under §1104 is anomalous. In Grogan v. Garner, 498 U.S. 279, 111 S. Ct. 654, 112 L. Ed. 2d 755 (1991), a unanimous Court determined that a preponderance of the evidence standard should be applied when determining whether the exception to discharge provided for by 11 U.S.C. §523(a)(2)(A) had been met. See also Palmacci v. Umpierrez, 121 F.3d 781, 787 (1st Cir. 1997) (“The standard of proof of each element of a §523 claim is by a preponderance of the evidence.”). Cf. Xerox Fin. Servs. Life Ins. Co. v. Sterman (In re Sterman), 244 B.R. 499, 504 (D. Mass. 1999) (“Under §727(a) of the Bankruptcy Code, the burden of persuasion rests with the party opposing the discharge. The objecting party must prove each element of its objection to a discharge by a preponderance of the evidence.”) (citations omitted).

The statutory language addressed by Grogan provides that:

(a) A discharge under §§727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt —

* * * *

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by —

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor’s or insider’s financial condition . . .

11 U.S.C. §523(a). The Court’s reasoning in applying a preponderance standard for establishing such causes not to discharge counsels against imposing a heightened evidentiary standard elsewhere in the bankruptcy context without express congressional direction.

Grogan noted that the statute and its legislative history, along with that of its predecessor “does not prescribe the standard of proof for the discharge exceptions” and that “this silence is inconsistent with the view that Congress intended to require a special, heightened standard of proof.” Grogan, 498 U.S. at 286. And, in determining whether a heightened standard is appropriate, the court observed that “because the preponderance-of-the-evidence standard results in a roughly equal allocation of risks of error between litigants, we presume that this standard is applicable in civil actions between private litigants unless particularly important individual interests or rights are at stake.” Id. (quoting Herman & MacLean v. Huddleston, 459 U.S. 375, 389-90, 103 S. Ct. 683, 74 L. Ed. 2d 548 (1983)). The Court did not find any such interests implicated in Grogan and I find none exist here.

A “presumption” that a debtor remain in possession is, to be sure, based on the notion that the debtor is generally best equipped to oversee the company’s reorganization. This basis touches on the “fresh start” policy of the code: “to provide a procedure by which certain
insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.”” *Id.* (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 244, 54 S. Ct. 695, 78 L. Ed. 1230 (1934)). The *Grogan* Court, however, was “unpersuaded by the argument that the clear-and-convincing standard is required to effectuate” this policy, as am I in this setting. The policy is designed to provide an “unencumbered new beginning to the honest but unfortunate debtor.”” *Id.* at 286-87 (quoting *Local Loan Co.*, 292 U.S. at 244) and, the Court continued:

The statutory provisions governing nondischargeability reflect a congressional decision to exclude from the general policy of discharge certain categories of debts—such as child support, alimony, and certain unpaid educational loans and taxes, as well as liabilities for fraud. Congress evidently concluded that the creditors’ interest in recovering full payment of debts in these categories outweighed the debtors’ interest in a complete fresh start. We think it unlikely that Congress, in fashioning the standard of proof that governs the applicability of these provisions, would have favored the interest in giving perpetrators of fraud a fresh start over the interest in protecting victims of fraud. Requiring the creditor to establish by a preponderance of the evidence that his claim is not dischargeable reflects a fair balance between these conflicting interests.

*Id.* at 287.

The argument that §1104(a)(1), by defining “cause” in a way that includes fraudulent conduct, requires a heightened standard is also vitiated by the reasoning of *Grogan*. There, the court found that “the fact that most States required fraud claims to be proved by clear and convincing evidence would not support the conclusion that Congress intended to adopt the clear-and-convincing standard for the fraud discharge exception.” *Id.* at 288.

Unlike a large number, and perhaps a majority, of the States, Congress has chosen the preponderance standard when it has created substantive cause of action for fraud. Most notably, Congress chose the preponderance standard to govern determinations under 11 U.S.C. §727(a)(4), which denies a debtor the right to discharge altogether if the debtor has committed a fraud on the bankruptcy court.

*Id.* at 288-89 (citations omitted).

Here, also, there is no reason to import from the common law of certain states a heightened standard of proof to establish a §1104(a) exception, especially where there are so many recognized bases for appointing a trustee other than fraud. Congress did not distinguish fraudulent from non-fraudulent grounds. Nor did it indicate a specific evidentiary standard. Consequently, *Grogan* teaches that there is no reason to establish a heightened burden on the moving party.
Turning back to the implied foundation of the “presumption” that current management can best run the debtor’s business and its implications for a “clear-and-convincing” standard in the lower court case law, it must be recognized that if what is ordinarily true is equated with a strong presumption, then a presumption is triggered in almost all civil contexts. People are not normally negligent, and one could say it is “extraordinary” when individuals are “grossly” negligent, but that has not warranted a heightening of the burden of proof in civil cases. There is even less reason for heightened burdens in bankruptcy proceedings in general, where the court is given broad equitable powers, and in the §1104(a) context in particular, where numerous considerations requiring some balancing are placed before the bankruptcy court by the statute itself.

Consequently, I conclude that under §1104(a), factual findings for appointment of a trustee must be made to a preponderance of the evidence by the appointing judge, and should be reviewed under a clearly erroneous standard, while the determination that such evidence is sufficient to show cause for appointment will be evaluated for an abuse of discretion. If the factual findings supporting the determination are not clearly erroneous and the discretionary choice falls within the range of reasonable judicial determinations, there is no basis to find such an appointment to be out of the permissible bounds of §1104(a).

In sum, although I reject the adoption of the “clear and convincing” evidentiary standard found in the case law, I believe that I am simply following the implications of Grogan for bankruptcy law when Congress has not explicitly adopted a standard different from the traditional preponderance standard. What is clear from the cases is that absent an application to the court, a debtor will retain possession; that if an application is made, the moving party must establish “cause” or “interest” by a preponderance, and that, in deciding that motion, a bankruptcy court—in accordance with its broad discretionary powers—must be persuaded that the occasion exists for appointment of a trustee. There is no persuasive explanation provided for requiring a clear and convincing standard of evidentiary proof, and in light of Grogan, despite consistent invocation by other lower courts, I do not believe the First Circuit would or should adopt such a heightened standard.

C. Bankruptcy Court’s Decision

Turning to the case at hand, the parties offer no reason to question that the judge was persuaded, at least by a preponderance of the evidence, that both §1104(a)(1) and §1104(a)(2) were satisfied. The bankruptcy court did not explain its expedited decision in great detail. I will, therefore, review the arguments and information it was provided to determine whether a sufficient factual basis exists for the court, within its discretion, to conclude that the requirements of §1104(a) had been met.

The Trustee summarized the bases upon which its request for a trustee appointment rest:

Verified documents and testimony proffered by the Debtor revealed that the Tradex through its principal, Gitto, failed to make straightforward and accurate disclosures to the court when the Debtor’s schedules did not include all the Debtor’s assets, liabilities, and payments made to insiders. The documents and testimony also revealed that Gitto improperly engaged
in questionable inter-company transactions and commingled the affairs of Tradex with those of Gitto Global by causing Tradex to grant a mortgage on its assets to collateralize [sic] a sale for the benefit of Gitto Global. Moreover, Tradex and Gitto were unable to substantiate Tradex’s undocumented acquisition of the Vitrolite inventory. In addition, a grand jury investigation into allegations of fraud on the part of Tradex and Gitto was underway, which militated in favor of a trustee because this meant the debtor’s management would be devoting significant attention to that matter—time that necessarily would come at the expense of the debtor’s critical efforts to simultaneous reorganize and thereby enhance creditor recoveries. Further Gitto’s decision to not make himself available to answer questions regarding the business and financial affairs of the Debtor meant the Debtor could not explain the serious inconsistencies between the debtor’s tax returns and the statements the debtor made under penalty of perjury in its bankruptcy filing...Furthermore the Debtor’s creditors have levied substantial allegations, through related litigation and through Clinton’s relief from stay motion, of bad faith, fraud and serious law enforcement violations. Finally, the bankruptcy court had previously found that Gitto had been siphoning excessive management fees from the Debtor’s cash flow.

(Appellee’s Brief at 13-14 (citations omitted).) Although certain of these allegations are disputed—in particular those surrounding the Vitrolite inventory and the implication of the court’s finding regarding the “management fees”—the bankruptcy court appears to have credited a critical mass of the foregoing.

I begin by noting that the evidence before the bankruptcy court, compared to that relied upon by other courts, would appear sufficient to satisfy even a “clear and convincing” standard. The bankruptcy court did not expressly apply such a heightened standard, however, and nor, for the reasons set forth above, do I.

First, and perhaps most importantly, the inconsistencies and inaccuracies arising in the §341 process raise serious concerns. “One of the most fundamental and crucial duties of a debtor-in-possession upon the filing of a chapter 11 petition is to keep the Court and creditors informed about the nature, status and condition of the business undergoing reorganization.” Savino, 99 B.R. at 526. Consequently, “where, as here, the Debtor fails to disclose material and relevant information to the Court and creditors, a chapter 11 trustee is required.” Id.; see In re Oklahoma Refining Co., 838 F.2d 1133, 1136 (10th Cir. 1988) (“It is also established that failure to keep adequate records and make prompt and complete reports justifies the appointment of a trustee.”); Ford, 36 B.R. at 504 (“Inherent in debtor’s fiduciary obligations under the Code is the duty to file accurate financial reports disclosing all transactions involving estate assets . . .

Any failure to file accurate financial statements is an omission contributing to cause for appointment of a trustee.”); see also Sanders, 2000 Bankr. 263, at *11 (“Where a debtor fails to disclose material information to the Court and to the creditors, the appointment of a chapter 11
trustee is appropriate. Misrepresenting the facts of a debtor’s financial situation constitutes grounds for the appointment of a trustee.”).

More particularly, a failure to provide accurate schedules to the court has been deemed sufficient “cause” under §1104(a)(1). See Sanders, 2000 Bankr. 263; see also Deena Packaging, 29 B.R. at 707 (“Section 1104 ... specifically proscribes certain conduct by debtors in possession; dishonesty is one such enumerated, prohibited act ... The trial record reveals that Deena’s failure to include relevant financial data on their original and amended schedules raises questions of dishonest conduct.”). The debtor first failed to submit schedules and later, after a denial of a request for an extension of time, submitted schedules contradicted by the testimony of Mrs. Gitto and tax returns not filed until the eve of the hearing held by the bankruptcy judge. Such facts call into question Mr. Gitto’s assertion that these were simply oversights. And, even if they were, they are sufficient to raise questions about the ability of the bankruptcy court and creditors to rely upon Mr. Gitto’s statements. Moreover, to the extent Mr. Gitto attempts to justify inaccurate statements by contending that Mrs. Gitto did not have a thorough understanding of the issues, that circumstance is his own doing. His unwillingness to testify prevents the bankruptcy court and creditors from receiving direct information regarding the ongoing management of the company from the person entrusted to act as a fiduciary.

The management of the company, Mr. Gitto contends, is so simple that there is no need for a trustee appointment. In this regard, Mr. Gitto would have it both ways. He talks about how simple the business of the company is, yet cites the cost of a trustee. He emphasizes how he only needs to receive checks and issue bills, but there were a series of unexplained “oversights” regarding this “simple” business and, in seeking an extension of time for filing its §521 statement, the debtor referred to “the extremely complicated nature of the case, including difficulties accurately ascertaining and scheduling the Debtor’s various assets and liabilities.” (App. 361-62.) To the extent the business is simple, the cost of the trustee is minimized. Moreover, the simplicity of the business weakens any “presumption” that might exist regarding a debtor remaining in possession. The presumption after all is based on the idea that a debtor is in the best position to understand the intricacies of the industry. As the court in Petit noted,

the rationale for the presumption of a debtor remaining in possession of the estate has limited applicability here. In a typical chapter 11 proceeding, the “Debtor” will be a business run by individuals with experience in that business. As long as there are no findings of fraud or other mismanagement by the current management, it can be assumed that the business would fare better being run by experienced management during the reorganization process. Here the Debtor is an individual who owns only one remaining asset, the cause of action. Thus, there is no “business” that requires day-to-day operation to generate profits. Accordingly, there is less of a need to have the Debtor continue in the management of her affairs.

Petit, 182 B.R. at 69 n. 7. So, too, here, where the debtor contends that all that needs to be done is the collection of rent and the arrangement of a sale of Tradex. There is no reason to question that a trustee can adequately perform these functions; and, there is substantial evidence calling
into question the faith the court and debtors can have in the transparency and reliability of any statements made by Mr. Gitto, assuming that he is even willing to make statements on relevant matters.

The existence of a grand jury investigation and civil suits pursuing allegations relating to Mr. Gitto’s business actions in regard to Tradex and other companies is also relevant to a determination regarding trustee appointment. *Cf. Oklahoma Refining*, 838 F.2d at 1136 n.2 (“Case law also supports lenders’ claims that debtor’s effort to manage the company was impeded by the existence of at least four criminal cases pending against either the debtor’s president…or some of the affiliated companies.”). Here, the bankruptcy judge was aware of such allegations not only through the trustee appointment process but also by virtue of overseeing a related bankruptcy proceeding. It would be inconsistent with the discretion and equitable powers afforded a bankruptcy court judge not to permit him to add such knowledge and experience to the balance.

Finally, questionable business transactions with related companies may also serve as grounds for appointment of a trustee. *See Oklahoma Refining*, 838 F.2d at 1136 (“There are many cases holding that a history of transactions with companies affiliated with the debtor company is sufficient cause for the appointment of a trustee where the best interests of the creditors require.”). Such transactions appear in the record of the Bankruptcy Court regarding the debtor and affiliated entities here.

The bankruptcy court also referenced (a)(2) when appointing the trustee. One of the major debtors, LaSalle, voiced support for appointment and another, Clinton, was silent as to appointment at the hearing before the bankruptcy court. LaSalle is a plaintiff in a major lawsuit before me in the district court against Mr. Gitto and other principals of related organizations. Those proceedings and any resulting tensions between the parties were considered sufficiently factual by the court when evaluating the appropriateness of appointing a trustee. 7 *Collier on Bankruptcy* §1104.02 [3] [d] [ii] (15th ed. rev.). The balance of interests here were sufficient to support the factual predicate under §1104(a) (2).

In sum, it is clear from the record placed before the bankruptcy court that inaccuracies and inconsistencies existed in the statements made by the debtor and its principals. There is no basis to question this factual predicate, and I find that it would not have been an abuse of discretion for the court to determine that such evidence established “cause” under §1104(a)(1). There was also more information before the court from this case which, evaluated in light of his experience with this and related cases, supplied sufficient grounds to find “cause” existed for purposes of §1104(a)(1) and that appointment was warranted under §1104(a) (2).

In short, even if there was insufficient evidence “that fraud or some other §1104 (a) (1) ground actually existed, the testimony was more than adequate to demonstrate to the bankruptcy court the extent to which the Debtor’s creditors cannot place confidence in her to carry out her fiduciary obligations in their interest.” *Petit*, 182 B.R. at 70. *Cf. Oklahoma Refining*, 838 F.2d at 1136 (“It is clear, both from the language of the statute and established case law, that the court need not find any of the enumerated wrongs in order to find cause for appointing a trustee. It is sufficient that the appointment be in the interest of creditors.”).
IV. Conclusion

For the foregoing reasons, the decision of the bankruptcy court to appoint a chapter 11 trustee for TRADEX is AFFIRMED.
Chapter 19
OUT-OF-COURT WORKOUTS, PREPACKS,
AND PRE-ARRANGED CASES: A BRIEF INTRODUCTION

Out-of-Court Workouts

When you start to learn about chapter 11, they tell you how the debtor calls its creditors together and cuts—or fails to cut—a deal.

The alert student will say: That’s all? If that is all there is to it, why do they need bankruptcy? Indeed, why do they need a court? Why not—well, why not just cut the deal?

Very good question. And the answer is: Very often, they do. Debtors have always cut deals with creditors. A fair number of us make a decent living by orchestrating these out-of-court workouts. Indeed, the better measure of success as a restructuring lawyer is the number of cases we keep out of bankruptcy, not the number we take in.

There are some obvious advantages to an out-of-court workout. It is likely to be quicker and cheaper than a chapter 11 case. You may be able to sidestep a lot of paperwork and you avoid a lot of unwanted attention.

But there are also some clear disadvantages. If there are more than a handful of creditors, just trying to orchestrate all the parties can prove to be an insurmountable hurdle. Moreover, even if you get agreement from a lot of creditors, there is no way to keep dissenters in line. Dissenters and holdouts may see an opportunity to achieve a disproportionate recovery. They can derail the whole operation by demanding a precipitous levy. Or they can simply refuse to accept the deal.

There are, as we have discussed in prior chapters, a number of protections you can achieve in chapter 11 that may not be available outside. You can, for example, hold creditors at bay through the automatic stay. You can impose the plan on dissenters through §§1126 and 1129. You can use the rejection powers of §365 to get rid of burdensome contracts. And you can avoid and recover prior payments under chapter 5. Moreover, there may be tax advantages to doing your deal in bankruptcy. For example, the cancellation of debt in a chapter 11 case is ordinarily not included in gross income (although it does reduce tax attributes). See IRC §108. If you do the same deal outside of bankruptcy, you may have a big tax bill. If you need these protections, then chapter 11 is the card you are likely to play.

If, however, the only thing about your company that is broken is its balance sheet, then the mere threat of chapter 11 may be enough to trigger out-of-court settlement. The Bankruptcy Code is now more than a quarter of a century old. Parties—in particular, creditors—are a good deal more sophisticated now than they were then, are better able to understand the potential cost of chapter 11, and are more willing to accept a settlement rather than to fall into the briar patch.
Of course, creditors may sometimes prefer chapter 11, even with the added expense. If you don’t trust the debtor, you may be happy to have some judicial supervision. And in bankruptcy you don’t have to worry quite as much about another creditor cutting a faster and better deal than you, since the Bankruptcy Code assures equality of distribution to similarly situated creditors.

**Prepacks**

A prepackaged bankruptcy (or “prepack”) is a form of consensual chapter 11 restructuring that significantly reorders the traditional reorganization process. “Prepackaging” a chapter 11 reorganization enables a debtor to minimize the impact to its ongoing business operations by combining many of the best aspects of out-of-court workouts—cost-efficiency, speed, flexibility, and cooperation—with the binding effect and structure of a conventional bankruptcy.

Unlike a traditional chapter 11 case, the prepackaged bankruptcy is negotiated and accepted by creditors before a proceeding is commenced in the bankruptcy court. In theory, therefore, the prepackaged bankruptcy itself can be quick (sometimes as fast as 30 to 45 days), and therefore, less costly and damaging to the restructuring company. It is particularly useful for those businesses that are very sensitive to public image, such as retailers. If they are in bankruptcy for a long time, the public may become skeptical and their image may be tarnished, sometimes beyond repair. If they can get in and out quickly and without a lot of public fighting, they have a better chance to emerge unscathed.

In a prepackaged case, the debtor negotiates and drafts a plan of reorganization. It then circulates the plan accompanying disclosure statement, and ballot to creditors. The creditors have a period of time to review the disclosure statement and vote on the plan. If the debtor receives sufficient votes to confirm the plan, it then files a bankruptcy petition, the plan, the disclosure statement, and the ballots, all at the same time. If it works, most of the action is done before the company is in bankruptcy. In bankruptcy, the debtor just needs retroactive approval of the disclosure statement and confirmation of the plan.

The Bankruptcy Code recognizes the prepackaged case. Take a look at §§1125(g) and 341(e). This section allows the court to count votes on a plan that were solicited before the case was filed, so long as the acceptance does not violate other law, and so long as the voting creditors had the advantage of the same sort of information they would have received before voting in chapter 11.

In a large “public company” case, the negotiations often revolve around the bondholders. For the bondholder, an imaginative observer might ask: why not simply put a provision into the original bond agreement, providing that a plan accepted out of court will be binding on dissenters.

The answer to that question is that the law doesn’t allow it. “Public” bond issues are governed by the Trust Indenture Act of 1939 (11 U.S.C. §77aaa). The Trust Indenture Act
Chapter 19 - Out of Court
Workouts, Prepacks, and Pre-Arranged Cases: A Brief Introduction

specifically provides (§316(b)) that the rights of a bondholder shall not be impaired without his consent. The provision is nonwaivable (§327). This rule, coupled with the practical inability to get all bondholders to the proverbial table (or to even know who they are) probably explains the bulk of the public company prepack action.

So why doesn’t everyone use a prepack if it is quicker and cheaper than a normal chapter 11 case? First, you need to have the kind of case where you can make a deal with a large majority of creditors before bankruptcy. That depends in large part on the nature of your creditor constituency. If the creditor group is relatively small, and the debt is fairly concentrated, maybe you can get together, make a deal, and then “run it through bankruptcy.” Even if you can’t make a deal with everyone, you can get agreement from the required majority and bind dissenters. But if you have hundreds of bondholders and trade creditors, with little concentration of the debt, you’re not likely to be able to use the prepack.

There are some risks to a prepack. You do the solicitation based on a disclosure statement that has not been blessed by the court in advance. A dissenter may come in after the fact and challenge the adequacy of the disclosure and/or the method of soliciting votes. If the court sustains the challenge, you have to “do it over again.” This can be expensive, cause delay, and sometimes delay the whole process. It used to be that dissenters would sometimes try to derail a prepack by filing an involuntary petition during the solicitation period, forcing the debtor to “start over.” BAPCPA attempted to limit the impact of this tactic by providing, in §1125(g), that a solicitation begun prior to the bankruptcy filing may continue after the filing.

Take a look at Appendix 19(a). It is a reproduction of much of the prepack guidelines of the Bankruptcy Court for the Southern District of New York.

Partial Prepacks

There are some cases where you can solicit certain classes of creditors before filing chapter 11 and other classes afterward. These are referred to as partial prepacks. There are several reasons you might do this. Let’s say you have a case with a large bank, a relatively small group of bondholders, and a thousand trade creditors each of which is owed a thousand dollars or so. You can probably make a deal with a majority in number and two-thirds in debt amount of the bank class and bondholder class, but it is not practical with the dispersed group of small trade creditors. So maybe you solicit the bank and bonds before bankruptcy and then file and solicit the trade in chapter 11, after obtaining approval of the disclosure statement. It may even be that you have a better chance of quick acceptance from the trade if you can tell them that you already have a deal with the bank and the bonds (which presumably has something in it for the trade).

There are also securities law driven reasons for this approach sometimes. If the consideration being given to creditors under the plan is securities, then ordinarily the debtor must prepare and file a registration statement with the Securities and Exchange Commission. This is a time consuming and expensive process. Bankruptcy Code §1145 provides an exemption for securities that are distributed under a plan of reorganization in exchange for claims or interests (or principally in exchange for claims and interests and partially in exchange for cash or other
property). But the exemption does not appear to apply to pre-petition solicitations. To deal with this problem, the debtor will sometimes do pre-petition solicitation of those classes where the §1145 exemption is not necessary (such as those classes that are not getting securities under the plan) and post-petition solicitation for those classes where the exemption is needed.

**Pre-Arranged or Pre-Negotiated Cases**

The terms “pre-arranged bankruptcy” or “pre-negotiated bankruptcy” do not have specific definitions. In its most general sense, they refer to any chapter 11 case in which the debtor has discussed with some constituency prior to the commencement of bankruptcy some form of corporate reorganization or restructuring to be accomplished through the chapter 11 process and has received some form of commitment (which may or may not be contractual or binding by its terms) from the constituency to support a chapter 11 plan that accomplishes that reorganization or restructuring.

Generally, however, a pre-arranged or pre-negotiated bankruptcy refers to a reorganization or restructuring that is, prior to the commencement of bankruptcy, (1) negotiated with representatives of the most significant constituencies that are expected to be impaired and whose acceptance is sought or needed for confirmation (i.e., the senior lenders, the bondholders, and principal equity security holders), (2) agreed to by those representatives (even if those representatives, by themselves, are not sufficient in number or amount to assure acceptance of the particular classes of debt that they represent), and (3) memorialized in written agreements containing the basic terms of a plan of reorganization.

The most significant procedural difference between a pre-arranged plan and a prepackaged plan is that solicitation occurs after the bankruptcy case has been filed and after the court has approved a disclosure statement.

Sometimes, in lieu of a vote (as one would get in a pre-pack) the debtor tries to get an agreement by the creditors to support a plan that contains certain basic terms, which is sometimes referred to as a “lock-up agreement.” This is common in cases involving an outside investor, who may want to know that the creditors will support its transaction before devoting the necessary resources. While most lock-up agreements are entered into before bankruptcy, post-petition lockups have been criticized by courts, particularly in Delaware, as violating the solicitation rules of §1125. If you are thinking of entering into a post-petition lockup agreement, have a look first at Judge Walrath’s decisions in *NII Holdings Inc.*, Case No. 02-11505 and *NII Holdings Inc.*, Case No. 02-11505 (MFW).
APPENDIX 19(a)
PRE-PACKAGED CHAPTER 11 GUIDELINES

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In the Matter of the Adoption of Prepackaged Chapter 11 Case Guidelines

By resolution of the Board of Judges for the Southern District of New York; it is resolved that in an attempt to provide bankruptcy practitioners with guidelines in dealing with practical matters when filing a prepackaged Chapter 11 case, including filing all documents via the Internet by means of the Court’s Electronic Case Filing System; Prepackaged Chapter 11 Case Guidelines, annexed hereto, to be revised from time to time as new features are added to the Court’s Electronic Case Filing System, be and the same hereby are adopted and are to take effect as of the date of this order.

Dated: New York, New York
February 2, 1999

/s/Tina L. Brozman
Judge Tina L. Brozman
Chief Bankruptcy Judge
PROCEDURAL GUIDELINES FOR PREPACKAGED
CHAPTER 11 CASES IN THE
UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

I. GOALS.

The purpose of this document is to establish uniform guidelines for commencing and administering "prepackaged Chapter 11 cases" in the United States Bankruptcy Court for the Southern District of New York (the "Court"). Specifically, this document defines "prepackaged Chapter 11 case" and attempts to provide bankruptcy practitioners with help in dealing with practical matters which either are not addressed at all by statute or rules or are addressed indirectly in a piecemeal fashion by statutes, general rules, and/or local rules that were not enacted specifically with prepackaged Chapter 11 cases in mind. Although each case is different, many issues are common to all prepackaged cases. Judicial economy, as well as procedural predictability for debtors and creditors, will be enhanced by promulgation of uniform guidelines to deal with these common issues. The guidelines are advisory only; the Court retains the power to depart from them.

In order to ease the burden on practitioners and the Court, Chief Judge Tina L. Brozman convened a committee of judges, attorneys, clerk's office staff and the United States Trustee to assist in developing a uniform set of procedures applicable to prepackaged Chapter 11 cases filed in the Southern District of New York. Those meetings resulted in a general order adopted by the Court on February 2, 1999, after a
vote of the Board of Judges, which established the following procedural guidelines
for prepackaged Chapter 11 cases.

II. DEFINITION OF PREPACKAGED CHAPTER 11 CASE.

For purposes of these guidelines, a "prepackaged Chapter 11 case" is one in
which the Debtor, substantially contemporaneously with the filing of its Chapter 11
petition, files a Confirmation Hearing Scheduling Motion For Prepackaged Plan in
substantially the form annexed hereto as Exhibit A and satisfying the criteria set forth
in Part III.A. below ("Prepack Scheduling Motion"), plan, disclosure statement (or
other solicitation document), and voting certification.

III. CRITERIA FOR PREPACKAGED CHAPTER 11 CASE;
CONTENTS OF PREPACK SCHEDULING MOTION.

A. Content of Prepack Scheduling Motion.

The Prepack Scheduling Motion shall:

(i) represent that (x) the solicitation of all votes to accept or reject the
Debtor's plan required for confirmation of that plan was completed prior to com-
mencement of the Debtor's Chapter 11 case, and that no additional solicitation of
votes on that plan is contemplated by the Debtor, or (y) the solicitation of all votes to
accept or reject the Debtor's plan required for confirmation of that plan has been
deemed adequate by the Court pursuant to Part III. C.(ii) below such that no addi-
tional solicitation will be required;
(ii) represent that the requisite acceptances of such plan have been obtained from each class of claims or interests as to which solicitation is required except as provided in Part III.A.(iii) below; and

(iii) with respect to any class of interests that has not accepted the plan whether or not it is deemed not to have accepted the plan under §1126(g), represent that the Debtor is requesting confirmation under §1129(b); and

(iv) request entry of an order scheduling the hearing (x) on confirmation of the plan and (y) to determine whether the Debtor has satisfied the requirements of either 11 U.S.C. § 1126(b)(1) or 11 U.S.C. § 1126(b)(2), for a date that is not more than ninety (90) days following the petition date.


A Chapter 11 case may constitute a "prepackaged Chapter 11 case" for purposes of these guidelines notwithstanding the fact that the Debtor proposes to confirm the Plan pursuant to 11 U.S.C. § 1129(b)(2)(C) as to a class of interests.

C. Filing of Petition After Solicitation Has Commenced But Before Expiration of Voting Deadline.

Unless the Court orders otherwise, if a Chapter 11 case is commenced by or against the Debtor, or if a Chapter 7 case is commenced against the Debtor and converted to a Chapter 11 case by the Debtor pursuant to 11 U.S.C. § 706(a), after the Debtor has transmitted all solicitation materials to holders of claims and interests
whose vote is sought but before the deadline for casting acceptances or rejections of the Debtor's plan (the "Voting Deadline"),

(i) the Debtor and other parties in interest shall be permitted to accept but not solicit ballots until the Voting Deadline; and

(ii) After notice and a hearing the Court shall determine the effect of any and all such votes.

D. Applicability of Guidelines To Cases Involving Cramdown of Classes of Claims and Interests and "Partial Prepackaged Chapter 11 Cases."

The Court may, upon request of the Debtor or other party in interest in an appropriate case, apply some or all of these guidelines to

(i) cases in which the Debtor has satisfied the requirements of Part III.A.(i) above but intends to seek confirmation of the plan pursuant to 11 U.S.C. § 1129(b) as to a class of (a) claims which is deemed not to have accepted the plan under 11 U.S.C. § 1126(g); (b) claims or interests which is receiving or retaining property under or pursuant to the plan but whose members' votes were not solicited prepetition and whose rejection of the plan has been assumed by the Debtor for purposes of confirming the plan; or (c) claims or interests which is receiving or retaining property under or pursuant to the plan and which voted prepetition to reject the plan, as long as no class junior to such rejecting class is receiving or retaining any property under or pursuant to the plan; and
(ii) "partial prepackaged Chapter 11 cases" -- i.e., cases in which acceptances of the Debtor's plan were solicited prior to the commencement of the case from some, but not all, classes of claims or interests whose solicitation is required to confirm the Debtor's plan.

IV. PREFILING NOTIFICATION TO UNITED STATES TRUSTEE AND CLERK OF THE COURT.

A. Notice of Proposed Filing to United States Trustee.

At least two (2) business days prior to the anticipated filing date of the prepackaged Chapter 11 case, the Debtor should (i) notify the United States Trustee of the Debtor's intention to file a prepackaged Chapter 11 case and (ii) supply the United States Trustee with two (2) copies of the Debtor's plan and disclosure statement (or other solicitation document).

B. Notice of Proposed "First Day Orders" to United States Trustee.

If possible, drafts of all First Day Motions (as defined in Part VI.A. below), with the proposed orders attached as exhibits, should be furnished to the United States Trustee at least one (1) and preferably two (2) business days in advance of the filing of the petition or as soon as practicable after the filing of an involuntary petition.

C. Notice of Proposed Filing to Clerk of Court.

At least two (2) business days prior to the anticipated filing date of the
prepackaged Chapter 11 case, counsel for the Debtor, without disclosing the name of
the Debtor, should contact the Clerk of the Court to discuss the anticipated filing, the
amount of the Debtor’s assets, number and type of creditors, procedures for handling
public inquiries (i.e., the names, addresses and telephone numbers of the persons to
whom such inquiries should be directed), procedures for handling claims and proofs
of claim or interest, whether the Debtor will request the Court to set a last date to file
proofs of claim or interest, and related matters. On request, the Clerk of the Court
will reserve a last date to file proofs of claim or interest for the Debtor. The Clerk of
the Court will not assign the case to or discuss the case with a judge until the petition
is filed.

V. FILING OF PREPACKAGED CHAPTER 11 CASE.

A. Electronic Case Filing Via the Internet.

The Court has established and requires electronic filing of all Chapter 11 cases on the
Internet. Information on electronic filing procedures, including a user's manual (copy
annexed as Exhibit “E”) and registration form, is available at the Court's world wide
web site at: http://www.nysb.uscourts.gov In electronically filing a prepackaged
Chapter 11 case, the Debtor should file the petition(s) first, followed by the affidavit
pursuant to Local Rule 1007-2 and the motions and proposed orders, and should file
lengthy documents, such as the disclosure statement (or other solicitation materials)
and plan, last. Electronically filing lengthy documents last will expedite the filing process. (See electronic filing instructions).

B. Proposed Orders as Exhibits to Electronically Filed Motions.

All “First Day Motions” (as defined in Part VI.A. below) shall have attached as an exhibit a copy of the proposed order sought to be signed.

C. Paper Copies Furnished to Assigned Judge.

As soon as practicable following filing of a prepackaged Chapter 11 case, the Debtor shall furnish to the judge assigned to the case a paper copy of the plan, the disclosure statement (or other solicitation document), “First Day Motions” (with proposed orders attached as exhibits), any other filed motion and any Order To Show Cause on which the Court’s signature is requested. Proposed Orders should be presented on a 3.5 inch disk in WordPerfect or other Windows-based format. (See electronic filing instructions). To the extent that documents filed by the Debtor at or following the commencement of the Debtor’s Chapter 11 case differ from the versions supplied to the United States Trustee under Parts VI.A. and IV.B. above, the Debtor shall furnish to the United States Trustee two (2) paper copies of any such documents that have been modified, preferably blacklined to show changes.

D. Abeyance of Local Rule 1007-2(e).
Notwithstanding Local Rule 1007-2(e), a proposed case conference order need not be submitted to the Court unless the confirmation hearing is delayed until a date that is more than ninety (90) days following the petition date.

VI. FIRST DAY ORDERS.

A. Motions for Request for Entry of Immediate Orders.

"First Day Orders" are orders which the Debtor seeks to have entered by the Court on or shortly after the filing of the petition. The request for a First Day Order should be made by motion (a "First Day Motion"), and a copy of the proposed First Day Order should be filed with and attached as an exhibit to the First Day Motion. First Day Motions may request a waiver of the requirement under Local Rule 9013-1 to file a separate memorandum of law only if the legal authority for the relief being sought is set forth in the First Day Motions.

B. Purpose of First Day Orders.

Generally, the purpose of First Day Orders is to deal with administrative matters ("Administrative Orders") and to ensure that the Debtor's business and operations are stabilized and conducted in a manner consistent with past practice and the proposed plan, pending consideration of confirmation of that plan ("Operational Orders"). While the Court recognizes the necessity and desirability of entertaining appropriate
First Day Motions, the terms and conditions of First Day Orders (particularly Operational Orders) necessarily will depend upon the facts and circumstances of the case, the terms of the plan, the notice given, and related factors, and will take into account the needs of the Debtor and the rights of other parties in interest.

C. **Typical First Day Motions and Orders.**

First Day Orders typically entertained by the Court on or within one (1) business day of the later of the petition date or the date of filing of the First Day Motions include (but are not limited to) the following:

1. Prepack Scheduling Motion, setting forth the information required in Part III above.¹

2. Motion for order directing joint administration of Debtors' cases if more than one case is commenced.

3. Motion for order authorizing Debtor to mail initial notices, including the notice of meeting of creditors under 11 U.S.C. § 341(a).

4. Motion for order (i) dispensing with the requirement of filing any or all schedules and statement of financial affairs in the event the Debtor is not seeking to bar and subsequently discharge all or certain categories of debt or (ii)

¹In the event solicitation has not been completed prior to the petition date, an alternative first day motion should be submitted consistent with sections III.A.(i) and III.C.
extending Debtor's time for filing schedules and statement of financial affairs to a specified date.

5. Motion for an order setting the last date for filing proofs of claim or interest if the Debtor has determined that a deadline should be set.

6. Applications to employ appropriate professionals, which may include:
   - attorneys
   - accountants
   - financial advisors.

If accountants, investment advisors, vote tabulators, solicitation agents or similar non-legal professionals were retained prepetition and are not seeking any payment in connection with the plan or the case in addition to payments that they received prior to the filing of the petition ("Additional Post-Petition Payments"), such professionals need not be retained pursuant to 11 U.S.C. § 327 and may continue to provide services to the Debtor with respect to the plan and the case (e.g., testifying at the confirmation/disclosure adequacy hearing); provided, however, that the post-petition services provided by accountants and financial advisors who have not been retained pursuant to 11 U.S.C. § 327 shall not include any work of a substantive nature, such as, for example, the preparation of new financial data, even if such accountants and financial advisors are not seeking any Additional Post-Petition Payments.
7. Motion for order authorizing employment and payment without fee applications of professionals used in ordinary course of business, not to exceed a specified individual and aggregate amount.

8. Motion for order establishing procedures for compensation and reimbursement of expenses of professionals.

9. Motion for order authorizing Debtor to maintain existing bank accounts and cash management system, and to continue using existing business forms (including checks) without "debtor-in-possession" designation. Any motion should describe the proposed cash management system and, in cases where money will be transferred between Debtors or from a Debtor to a non-debtor affiliate, represent why such transfers are desirable from the Debtor’s perspective, that the Debtor(s) will maintain records of all postpetition intercompany transfers of funds and describe what repayment terms exist.

10. Motion under 11 U.S.C. § 363 for interim order authorizing Debtor’s use of cash collateral on an emergency basis, pending a hearing, and providing adequate protection.

11. Motion under 11 U.S.C. § 364 for interim order authorizing Debtor to obtain postpetition financing on an emergency basis, pending a hearing.

Motion should disclose the amount of funds which the Debtor proposes to invest outside the statute's enumerated permitted investments and the proposed types of investments to be made. If the Debtor proposes to invest or deposit money in or with an entity that has not satisfied the requirement of 11 U.S.C. § 345 (b) (a "Non-Qualified Entity") the First Day Motion should demonstrate and explain why such an investment or deposit is necessary and, to the extent known, why the Non-Qualified Entity cannot or has not satisfied the requirements of 11 U.S.C. § 345(b).

13. Motion for order authorizing Debtor to pay (i) prepetition wages, salaries and commissions (including vacation, severance and sick leave pay) earned by an individual in an amount not to exceed specified per employee and aggregate amounts, which amounts shall be set forth in the Motion. If the Motion requests authority to pay amounts in excess of $4,300 (or such higher amount as is subsequently determined in accordance with 11 U.S.C. § 104(b)) per employee, then a list of the names and position/job titles of all employees as to whom those payments will be made shall be attached. However, the propriety of those requests shall be considered on a case by case basis. The Motion also shall state whether, and the extent to which, the claims proposed to be paid constitute priority claims under 11 U.S.C. § 507 ("Priority Claims") and, if such claims are not Priority Claims, the Motion should explain why those claims should be afforded the treatment requested in the Motion. The Motion may also ask the Court to direct banks to honor
prepensation checks for such amounts and authorize the Debtor to replace prepensation checks that have been dishonored.

14. Motion for order authorizing Debtor to pay claims for contribution to employee benefit plans in an amount not to exceed a specified amount, which amount shall be set forth in the Motion. If the Motion requests authority to pay amounts in excess of the amounts set forth in 11 U.S.C. § 507(a)(4) (as modified by 11 U.S.C. § 104(b)) then a list of the names and position/job titles of all employees as to whom those payments will be made shall be attached. However, the propriety of those requests shall be considered on a case by case basis. The Motion also shall state whether, and the extent to which, the claims proposed to be paid constitute Priority Claims and, if such claims are not Priority Claims, the Motion should explain why those claims should be afforded the treatment requested in the Motion.

15. Motion for an order authorizing Debtor to reimburse employee business expenses in an amount not to exceed a specified amount per employee and not to exceed a specified aggregate amount, which amounts shall be set forth in the Motion. The Motion also shall state whether, and the extent to which, the claims proposed to be paid constitute Priority Claims and, if such claims are not Priority Claims, the Motion should explain why those claims should be afforded the treatment requested in the Motion.
16. Motion for an order authorizing Debtor to pay creditors whose prepetition claims will be paid in full in cash on consummation under the Debtor's plan, not to exceed a specified aggregate amount, which amount shall be set forth in the Motion. The Motion should disclose the types of claims that the Debtor proposes to pay (e.g., trade creditors supplying goods; trade creditors supplying services; professionals involved in the routine, day-to-day operations and business of the Debtor). The Motion also shall state whether, and the extent to which, the claims proposed to be paid constitute Priority Claims and, if such claims are not Priority Claims, the Motion should explain why those claims should be afforded the treatment requested in the Motion.

17. Motion for an order authorizing Debtor to honor prepetition customer claims (e.g., refund of deposits, lay-a-way plans) and warranties, not to exceed specified aggregate and per claimant amounts, which amounts shall be set forth in the Motion. The Motion also shall state whether, and the extent to which, the claims proposed to be paid constitute Priority Claims and, if such claims are not Priority Claims, the Motion should explain why those claims should be afforded the treatment requested in the Motion.

18. Motion for an order authorizing continued performance without assumption under key executory contracts, including payment of prepetition amounts due and owing thereunder in an amount not to exceed specified aggregate and per
claimant amounts. The Motion shall list and state all contracts subject to the motion and whether, and the extent to which, the claims proposed to be paid are believed to be Priority Claims and, if such claims are not Priority Claims, the Motion should explain why those claims should be afforded the treatment requested in the Motion.

19. Motion for interim order prohibiting utilities from altering, refusing or discontinuing service on account of prepetition claims and establishing procedures for determining requests for additional adequate assurance.

20. In a case involving a sale of any or all of the Debtor's assets, Motion for order authorizing and scheduling auction at which the Debtor may sell its assets free and clear of claims and interests and approving auction procedures and related matters.

D. Request for Related Relief Need Not be Filed in Separate Motions.

Motions for related relief under First Day Orders referred to above need not be filed as separate motions. For example, in a given case it may be appropriate to combine cash collateral and financing motions, or deal with all employee-related matters in a single motion.

VII. VOTING PERIOD; BALLOT; MULTIPLE VOTES; NOTICE PRESUMPTIONS.

A. Voting Period Guidelines.

Fed.R.Bankr.P. 3018(b) requires the Court to consider whether "an unreasonably short" time was prescribed for creditors and equity security holders to
accept or reject the plan. Under ordinary circumstances, in determining whether the
time allowed for casting acceptances and rejections on the Debtor's plan satisfied
Fed.R. Bankr. P. 3018(b), the Court will approve as reasonable:

1. For securities listed or admitted to trading on the New York
Stock Exchange or American Stock Exchange or any international exchanges quoted
on NASDAQ, and for securities publicly traded on any other national securities
exchange ("Publicly Traded Securities"), a twenty (20) business day voting period,
measured from the date of commencement of mailing.

2. For securities which are not Publicly Traded Securities and for
debt for borrowed money which is not evidenced by a Publicly Traded Security, a ten
(10) business day voting period, measured from the date of commencement of
mailing.

3. For all other claims and interests, a twenty (20) business day
voting period, measured from the date of commencement of mailing.

B. **Shorter or Longer Voting Period.**

Nothing herein is intended to preclude (i) a shorter voting period if it
is justified in a particular case, or (ii) any party in interest from demonstrating that
the presumptions set forth above were not reasonable in a particular case.

C. **Ballot.**
1. The Debtor may, but shall not be required to, use a ballot substantially in the form of the Official Form of Ballot For Accepting or Rejecting A Plan (the "Prepackaged Chapter 11 Case Ballot Form attached as Exhibit ‘B’") in connection with a prepackaged plan solicitation.

2. Prepackaged Chapter 11 Master Ballot Form attached as Exhibit ‘C’ may be used to report voting by beneficial owners of claims and interests.

3. The ballot may include information in addition to that set forth on the Official Ballot Form, and may request and provide space for the holder of a claim or interest to vote on matters in addition to the plan. By way of example, the ballot may seek and record (i) votes relating to an exchange offer, (ii) consents to or votes with respect to benefits plans, and (iii) elections provided for in the plan (or exchange offer).

D. Multiple Votes.

If the holder of a claim or interest changes its vote during the prepetition voting period, only the last timely ballot cast by such holder shall be counted in determining whether the plan has been accepted or rejected unless the disclosure statement (or other solicitation document) clearly provides for some other procedure for determining votes on the prepackaged plan. If a holder of a claim or interest wants to change a vote post-petition, Rule 3018(a) requires a showing of cause and Court approval.
E. **Notice Guidelines.**

Fed.R.Bankr. P. 3018(b) requires the Court to consider whether the plan was transmitted to substantially all creditors and equity security holders of the same class. In making that determination, the Court will take into account (i) whether the Debtor transmitted the plan and disclosure statement (or other solicitation document) in substantial compliance with applicable nonbankruptcy law, rules, or regulations and (ii) the fact that creditors and equity security holders who are not record holders of the securities upon which their claims or interests are based generally assume the risk associated with their decision to hold their securities in "street name."

**VIII. ORGANIZATIONAL MEETING; CREDITORS’ COMMITTEE.**

A. After the filing of the Chapter 11 petition, the Debtor shall notify creditors of the date, time and place of the meeting of creditors pursuant to 11 U.S.C. § 341(a), as well as the other information set forth in Part X.B.2 below. The date set for the § 341(a) meeting should be no more than forty (40) days after the filing of the petition.

B. If a meeting of creditors pursuant to 11 U.S.C. § 341(a) has not yet been convened prior to the date upon which the plan is confirmed, no such meeting will be convened if the order confirming the plan or order entered substantially contemporaneously therewith contains a provision waiving the convening of such a meeting.
C. Typically, no creditors' committee will be appointed in a prepackaged Chapter 11 case where the unsecured creditors are unimpaired. However, where members of a pre-petition committee seek to serve as a member of an official creditors' committee, they shall demonstrate to the United States Trustee their compliance with Fed.R.Bankr.P. 2007(b).

IX. LAST DATE FOR FILING PROOFS OF CLAIM OR INTEREST.

A. A last date to file proofs of claim or interest will not be set unless the Debtor seeks an order fixing such a deadline for filing proofs of claim or proofs of interest.

B. As provided in Part IV.C. above, the Debtor should consult with the Clerk of the Court in advance of the filing of the case to discuss whether a last date to file proofs of claim or interest will be sought, the need for appointment of a claims' agent for the Court (at the Debtor's expense), and related matters.

C. If a claims' agent is appointed, such agent shall docket all proofs of claim and proofs of interest and deliver to the Debtor complete copies of the proofs of claim and interest, along with a complete claims and interest docket, not later than five (5) business days after the last date to file proofs of claim or interest.

D. Fed.R.Bankr.P. 2002(a)(7) requires at least twenty (20) days' notice by mail of the last day to file proofs of claim or interest. If the notice is being directed to creditors whose mailing addresses are outside the United States, the Court may extend the period beyond twenty days.
E. Paper copies of the notice of the last date to file proofs of claim or interest must be mailed as required under Fed.R.Bankr.P. 2002(n)(7).

X. NOTICE.

A. In General.

Notice of the filing of the plan and disclosure statement (or other solicitation document) and of the hearing to consider compliance with disclosure requirements and confirmation of the plan must be given to all parties-in-interest. Paper copy of a notice must be mailed; service of a notice of electronic filing will not suffice. No further distribution of the plan and disclosure statement (or other solicitation document) beyond that which occurred prepetition is required unless requested by a party-in-interest. Parties are advised to check General Order M-182 because paper copies of other notices may be required.

B. Hearing Notice.

1. Where the disclosure statement has not been approved by the Court prior to confirmation, the Debtor shall prepare and mail paper copies to all parties-in-interest of a Notice of Confirmation Hearing and Approval of Disclosure Statement (or other solicitation documents) in substantially the form annexed hereto as Exhibit "D" (the "Hearing Notice"). The Hearing Notice must:

   • set forth (i) the date, time and place of the hearing to consider compliance with disclosure requirements and confirmation of the plan, and
(ii) the date and time by which objections to the foregoing must be filed and served;

- include a chart summarizing plan distributions;
- set forth the name, address and telephone number of the person from whom copies of the plan and disclosure statement (or other solicitation document) can be obtained (at the Debtor's expense); and
- state that the plan and disclosure statement (or other solicitation document) can be viewed electronically and explain briefly how electronic access to these documents may be obtained.

2. Either the Hearing Notice or a separate notice must:
   - set forth the date, time and place of the §341(a) meeting and state that such meeting will not be convened if (i) the plan is confirmed prior to the date set for the §341(a) meeting and (ii) the order confirming the plan (or order entered substantially contemporaneously therewith) contains a provision waiving the convening of such a meeting.

C. Service.

1. The Hearing Notice shall be served upon (i) record (registered) holders of debt and equity securities (determined as of the record date established in the disclosure statement or other solicitation document) that were entitled to vote on the
plan, (ii) record (registered) holders of all other claims and interests of any class (determined as of a record date that is not more than ten (10) days prior to the date of the filing of the petition), (iii) all other creditors listed in the Debtor's schedules, unless Debtor is not seeking to bar and subsequently discharge claims, in which case schedules may not be required to be filed, (iv) the United States Trustee, (v) all indenture trustees, (vi) any committee(s) that may have been appointed in the case, and (vii) the United States in accordance with Fed.R.Bankr.P. 2002(j).

2. The Debtor shall inform the Court of the proposed procedures for transmitting the Hearing Notice to beneficial holders of stock, bonds, debentures, notes, and other securities, and the Court shall determine the adequacy of those procedures and enter such orders as it deems appropriate.

D. Time Period.

The Official Notice shall be mailed at least twenty (20) days prior to the scheduled hearing date on confirmation of the plan and adequacy of disclosure unless the Court shortens such notice period.

XI. COMBINED HEARINGS.

The hearings on the Debtor's compliance with either 11 U.S.C. § 1126(b)(1) or 11 U.S.C. § 1126(b)(2), as applicable, and on confirmation of the plan in a prepackaged Chapter 11 case shall be combined whenever practicable.
EXHIBIT “A”

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re: [NAME],
Debtor.

Chapter 11 Case No.
________________ (__) 
Tax ID No. _________

SCHEDULING MOTION FOR
PREPACKAGED CHAPTER 11 CASE

TO THE HONORABLE UNITED STATES BANKRUPTCY JUDGE:

The [NAME OF DEBTOR], as debtor and debtor in possession (the “Debtor”),
respectfully represents:

Background

1. [Brief background of the Debtor].

Jurisdiction and Venue

2. This Court has jurisdiction to consider this application pursuant to 28 U.S.C. §§ 157 and 1334. Consideration of this application is a core proceeding pursuant to 28 U.S.C. § 157(b). Venue of this proceeding is proper in this district pursuant to 28 U.S.C. §§ 1408 and 1409.

The Debtor’s Business

3. [Brief Description of the Debtor’s business].

The Proposed Plan of Reorganization

4. [Brief description of the proposed plan of reorganization].
This Court Should Schedule A Hearing  
To Consider Confirmation Of The Proposed Plan

5. Pursuant to section 1128(a) of the Bankruptcy Code, the Debtor requests that the Court set a hearing to consider confirmation of the Plan. Section 1128(a) of the Bankruptcy Code provides that “[a]fter notice, the court shall hold a hearing on confirmation of a plan.”

6. [Summarize results of pre-petition solicitation].

7. [Indicate whether Debtor requests that confirmation hearing and disclosure hearing be combined]. [Indicate proposed date and time for confirmation/disclosure hearings].

8. The Debtor proposes to publish notice of the Confirmation and Disclosure Compliance Hearing (the “Hearing Notice”) [insert where notice will be published]. [Indicate whether the proposed notice schedule complies with the minimum twenty-five (25) days’ notice required under Rules 2002(b) and 3017(a) of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”).]

9. In addition to the Hearing Notice, the Debtor will transmit, in accordance with Bankruptcy Rule 3017(d), via first class mail, postage prepaid, a copy of the Disclosure Statement and the Plan to all holders of claims against, or equity interests in, the Debtor other than [insert parties who received such materials pursuant to the prepetition solicitation], which are the parties to whom the Disclosure Statement and Plan have already been transmitted pursuant to the prepetition solicitation.

Notice

10. Notice of this application has been given to [insert names of persons to whom notice has been given] which shall include the U.S. Trustee, [others?].

1 A form of Hearing Notice, which includes a summary of the Plan, also is appended to the Guidelines.
11. No previous application for the relief sought herein has been made to this or any other court.

WHEREFORE the Debtor respectfully requests entry of an order granting the relief requested herein and granting the Debtor such other and further relief as is just.

Dated: __________, __________

By: __________________________
    [signing attorney]
    Attorneys for Debtor
EXHIBIT "B"

NO PERSON HAS BEEN AUTHORIZED TO GIVE ANY INFORMATION OR ADVICE, OR TO MAKE ANY REPRESENTATION, OTHER THAN WHAT IS INCLUDED IN THE MATERIALS MAILED WITH THIS BALLOT.

[NAME OF DEBTOR],

Debtor.

[DEBTOR'S ADDRESS]

Tax ID No. ____________

BALLOT FOR ACCEPTING OR REJECTING PREPACKAGED PLAN OF REORGANIZATION OF [NAME OF DEBTOR] UNDER CHAPTER 11 OF THE BANKRUPTCY CODE
BALLOT FOR VOTING ___% NOTES
(Class ___ : ___% NOTE CLAIMS)
[Insert Exact Name of Notes/Bonds, If Applicable]
[Insert CUSIP #, If Applicable]

If you are a beneficial owner of [NAME OF SECURITIES] (the "___% Notes") issued by [NAME OF DEBTOR], please use this Ballot to cast your vote to accept or reject the chapter 11 plan of reorganization (the "Plan") which is being proposed by [DEBTOR]. The Plan is Exhibit [ ] to the Disclosure Statement, dated ___, ___, ___. (the "Disclosure Statement"), which accompanies this Ballot. The Plan can be confirmed by the Bankruptcy Court and thereby made binding upon you if it is accepted by the holders of two-thirds in amount and more than one-half in number of claims in each class that vote on the Plan, and by the holders of two-thirds in amount of equity security interests in each class that vote on the Plan, and if it otherwise satisfies the requirements of section 1129(a) of the Bankruptcy Code. [If the requisite acceptances are not obtained, the Bankruptcy Court may nonetheless confirm the Plan if it finds that the Plan provides fair and equitable treatment to, and does not discriminate unfairly against, the class or classes rejecting it, and otherwise satisfies the requirements of section 1129(b) of the Bankruptcy Code.]

IMPORTANT

VOTING DEADLINE: ___ : ___ M., EASTERN TIME ON ___, ___.
REVIEW THE ACCOMPANYING DISCLOSURE STATEMENT FOR THE PLAN.
[BALLOTS WILL NOT BE ACCEPTED BY FACSIMILE TRANSMISSION.]
DO NOT RETURN ANY SECURITIES WITH THIS BALLOT. This Ballot is not a letter of transmittal and may not be used for any purpose other than to cast votes to accept or reject the Plan.

* This form ballot does not contemplate multiple securities within the same class.
## HOW TO VOTE

1. COMPLETE ITEM 1 (if not already filled out by your nominee) AND ITEM 2 AND COMPLETE ITEM 3 (if applicable).
2. REVIEW THE CERTIFICATIONS CONTAINED IN ITEM 4.
3. SIGN THE BALLOT (unless your Ballot has already been signed or “prevalidated” by your nominee).
4. RETURN THE BALLOT IN THE PRE-ADDRESS POSTAGE-PAID ENVELOPE (if the enclosed envelope is addressed to your nominee, make sure your nominee receives your Ballot in time to submit it before the Voting Deadline).
5. YOU WILL RECEIVE A SEPARATE BALLOT FOR EACH ISSUE OF SECURITIES YOU OWN WHICH IS ENTITLED TO BE VOTED UNDER THE PLAN.
6. YOU MUST VOTE ALL YOUR __% NOTES EITHER TO ACCEPT OR TO REJECT THE PLAN AND MAY NOT SPLIT YOUR VOTE.
Item 1. Principal Amount of __% Notes Voted. The undersigned certifies that as of [the record date] the undersigned was either the beneficial owner, or the nominee of a beneficial owner, of __% Notes in the following aggregate unpaid principal amount (insert amount in the box below). If your __% Notes are held by a nominee on your behalf and you do not know the amount, please contact your nominee immediately:


$  

Item 2. Vote. The beneficial owner of the __% Notes identified in Item 1 votes as follows (check one box only—if you do not check a box your vote will not be counted):

☐ to Accept the Plan. ☐ to Reject the Plan.

Item 3. Identify All Other __% Notes Voted. By returning this Ballot, the beneficial owner of the __% Notes identified in Item 1 certifies that (a) this Ballot is the only Ballot submitted for the __% Notes owned by such beneficial owner, except for the __% Notes identified in the following table, and (b) all Ballots for __% Notes submitted by the beneficial owner indicate the same vote to accept or reject the Plan that the beneficial owner has indicated in Item 2 of this Ballot (please use additional sheets of paper if necessary):

ONLY COMPLETE ITEM 3 IF YOU HAVE SUBMITTED OTHER BALLOTS

<table>
<thead>
<tr>
<th>Account Number</th>
<th>Name of Holder*</th>
<th>Principal Amount of Other __% Notes Voted</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$</td>
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<tr>
<td></td>
<td></td>
<td>$</td>
</tr>
</tbody>
</table>

* Insert your name if the notes are held by you in record name or, if held in street name, insert the name of your broker or bank.

Item 4. Authorization. By returning this Ballot, the beneficial owner of the __% Notes identified in Item 1 certifies that it (a) has full power and authority to vote to accept or reject the Plan with respect to the __% Notes listed in Item 1, (b) was the beneficial owner of the __% Notes described in Item 1 on ____________, and (c) has received a copy of the Disclosure Statement (including the exhibits thereto) and understands that the solicitation of votes for the Plan is subject to all the terms and conditions set forth in the Disclosure Statement.

Name: __________________________________________
(Print or Type)

Social Security or Federal Tax I.D. No.: ________________________________ (Optional)

Signature: ____________________________________________

By: ________________________________________________

Title: ________________________________________________

Street Address: _______________________________________

City, State, Zip Code: _________________________________

Telephone Number: ( )

Date Completed: ________________________________

No fees, commissions, or other remuneration will be payable to any broker, dealer, or other person for soliciting votes on the Plan. This Ballot shall not constitute or be deemed a proof of claim or equity interest or an assertion of a claim or equity interest.

YOUR VOTE MUST BE FORWARDED IN AMPLE TIME FOR YOUR VOTE TO BE RECEIVED BY [DEBTOR or DEBTOR'S AGENT], BY 12:00 M., EASTERN TIME, ON ____________, OR YOUR VOTE WILL NOT BE COUNTED. IF THE ENCLOSED ENVELOPE IS ADDRESSED TO YOUR NOMINEE, MAKE SURE YOUR NOMINEE RECEIVES YOUR BALLOT IN TIME TO SUBMIT IT BEFORE THE VOTING DEADLINE.
IF YOU HAVE ANY QUESTIONS REGARDING THIS BALLOT OR THE VOTING PROCEDURES, OR IF YOU NEED A BALLOT OR ADDITIONAL COPIES OF THE DISCLOSURE STATEMENT OR OTHER ENCLOSED MATERIALS, PLEASE CALL [DEBTOR or DEBTOR'S AGENT], AT ______________.
EXHIBIT “C”

NO PERSON HAS BEEN AUTHORIZED TO GIVE ANY INFORMATION OR ADVICE, OR TO MAKE ANY REPRESENTATION, OTHER THAN WHAT IS INCLUDED IN THE MATERIALS MAILED WITH THIS BALLOT.

[NAME OF DEBTOR], Debtor.

[DEBTOR’S ADDRESS]

Tax ID No. 

MASTER BALLOT FOR ACCEPTING OR REJECTING PREPACKAGED PLAN OF REORGANIZATION OF [NAME OF DEBTOR]

TO BE FILED UNDER CHAPTER 11 OF THE BANKRUPTCY CODE

MASTER BALLOT FOR VOTING _% NOTES

(Class 

[Insert exact name of Notes/Bonds]*

[Insert CUSIP # If Applicable]

THE VOTING DEADLINE BY WHICH YOUR MASTER BALLOT MUST BE RECEIVED BY [DEBTOR or DEBTOR’S AGENT] IS _______ M., EASTERN TIME ON _________, IF YOUR MASTER BALLOT IS NOT RECEIVED ON OR BEFORE THE VOTING DEADLINE, THE VOTES REPRESENTED BY YOUR MASTER BALLOT WILL NOT BE COUNTED.

This Master Ballot is to be used by you, as a broker, bank, or other nominee (or as their proxy holder or agent) (each of the foregoing, a “Nominee”), for beneficial owners of [NAME OF SECURITIES] (the “% Notes”) issued by [NAME OF DEBTOR], to transmit the votes of such holders in respect of their % Notes to accept or reject the chapter 11 plan of reorganization (the “Plan”) described in, and attached as Exhibit “ ” to the Disclosure Statement, dated _________ (the “Disclosure Statement”) provided to you. Before you transmit such votes, please review the Disclosure Statement carefully, including the voting procedures explained in Section 

The Plan can be confirmed by the Bankruptcy Court and thereby made binding upon you and the beneficial owners of % Notes for which you are the Nominee if it is accepted by the holders of two-thirds in amount and more than one-half in number of claims in each class that vote on the Plan, and by the holders of two-thirds in amount of equity security interests in each class that vote on the Plan, and if it otherwise satisfies the requirements of section 1129(a) of the Bankruptcy Code. [If the requisite acceptances are not obtained, the Bankruptcy Court may nonetheless confirm the Plan if it finds that the Plan provides fair and equitable treatment to, and does not discriminate unfairly against, the class or classes rejecting it, and otherwise satisfies the requirements of section 1129(b) of the Bankruptcy Code.]

PLEASE READ AND FOLLOW THE ATTACHED INSTRUCTIONS CAREFULLY. COMPLETE, SIGN, AND DATE THIS MASTER BALLOT, AND RETURN IT SO THAT IT IS RECEIVED BY [DEBTOR or DEBTOR’S AGENT] ON OR BEFORE THE VOTING DEADLINE OF _______ M., EASTERN TIME, ON _________, IF THIS MASTER BALLOT IS NOT COMPLETED, SIGNED, AND TIMELY RECEIVED, THE VOTES TRANSMITTED BY THIS MASTER BALLOT WILL NOT BE COUNTED.

* This form ballot does not contemplate multiple securities within the same class.

[Master Ballot Code]
Item 1. Certification of Authority to Vote. The undersigned certifies that as of the ___-___ record date, the undersigned (please check the applicable box):

☐ Is a broker, bank, or other nominee for the beneficial owners of the aggregate principal amount of ___% Notes listed in Item 2 below, and is the registered holder of such securities, or

☐ Is acting under a power of attorney and/or agency (a copy of which will be provided upon request) granted by a broker, bank, or other nominee that is the registered holder of the aggregate principal amount of ___% Notes listed in Item 2 below, or

☐ Has been granted a proxy (an original of which is attached hereto) from a broker, bank, or other nominee, or a beneficial owner, that is the registered holder of the aggregate principal amount of ___% Notes listed in Item 2 below,

and, accordingly, has full power and authority to vote to accept or reject the Plan on behalf of the beneficial owners of the ___% Notes described in Item 2 below.

Item 2. Class ___ (___% Note Claims) Vote. The undersigned transmits the following votes of beneficial owners in respect of their ___% Notes, and certifies that the following beneficial owners of ___% Notes, as identified by their respective customer account numbers set forth below, are beneficial owners of such securities as of the ___-___ record date and have delivered to the undersigned, as Nominee, Ballots casting such votes (Indicate in the appropriate column the aggregate principal amount voted for each account, or attach such information to this Master Ballot in the form of the following table. Please note: Each beneficial owner must vote all his, her, or its Class ___ claims (___% Notes) either to accept or reject the Plan, and may not split such vote):

<table>
<thead>
<tr>
<th>Your Customer Account Number for Each Beneficial Owner of ___% Notes</th>
<th>Principal Amount of ___% Notes Voted to ACCEPT the Plan</th>
<th>Principal Amount of ___% Notes Voted to REJECT the Plan</th>
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<tbody>
<tr>
<td>1.</td>
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<td>OR</td>
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<td>TOTALS</td>
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</tr>
</tbody>
</table>
**Item 3. Certification As to Transcription of Information From Item 3 As to Other ___% Notes Voted by Beneficial Owners.** The undersigned certifies that the undersigned has transcribed in the following table the information, if any, provided by beneficial owners in Item 3 of the ___% Note Ballots, identifying any other ___% Notes for which such beneficial owners have submitted other Ballots:

<table>
<thead>
<tr>
<th>YOUR customer account number for each beneficial owner who completed Item 3 of the ___% Note Ballot</th>
<th>TRANSCRIBE FROM ITEM 3 OF ___% NOTES BALLOT:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Account Number (Transcribe from Item 3 of ___% Note Ballot)</td>
<td>Name Holder (Transcribe from Item 3 of ___% Note Ballot)</td>
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<td>9.</td>
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<td>10.</td>
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</table>
Item 4. Certification. By signing this Master Ballot, the undersigned certifies that each beneficial owner of ___% of the Notes listed in Item 2, above, has been provided with a copy of the Disclosure Statement, including the exhibits thereto, and acknowledges that the solicitation of votes is subject to all the terms and conditions set forth in the Disclosure Statement.

Name of Broker, Bank, or Other Nominee:

(Print or Type)

Name of Proxy Holder or Agent for Broker, Bank, or Other Nominee (if applicable):

(Print or Type)

Social Security or Federal Tax I.D. No.: (If Applicable)

Signature: ____________________________

By: ________________________________ (If Appropriate)

Title: ______________________________ (If Appropriate)

Street Address: _______________________

City, State, Zip Code: ___________________

Telephone Number: ( ) __________________

Date Completed: _______________________

THIS MASTER BALLOT MUST BE RECEIVED BY [DEBTOR or DEBTOR'S AGENT], BEFORE __:__A.M., EASTERN TIME, ON ___, ____, ___ AND OR THE VOTES TRANSMITTED HEREBY WILL NOT BE COUNTED.

[PLEASE NOTE: BALLOTS AND MASTER BALLOTS WILL NOT BE ACCEPTED BY FACSIMILE TRANSMISSION.]

IF YOU HAVE ANY QUESTIONS REGARDING THIS MASTER BALLOT OR THE VOTING PROCEDURES, OR IF YOU NEED ADDITIONAL COPIES OF THE MASTER BALLOT, BALLOTS, DISCLOSURE STATEMENT, OR OTHER RELATED MATERIALS, PLEASE CALL [DEBTOR or DEBTOR'S AGENT], AT ____________.
INSTRUCTIONS FOR COMPLETING THE MASTER BALLOT

VOTING DEADLINE:

The Voting Deadline is __:__ m., Eastern Time, on ____, ____, unless extended by the Debtor. To have the vote of your customers count, you must complete, sign, and return this Master Ballot so that it is received by [DEBTOR or DEBTOR’S AGENT], [ADDRESS], on or before the Voting Deadline.

HOW TO VOTE:

If you are both the registered owner and beneficial owner of any principal amount of __% Notes and you wish to vote such __% Notes, you may complete, execute, and return to [DEBTOR or DEBTOR’S AGENT] either a __% Note Ballot or a __% Note Master Ballot.

If you are transmitting the votes of any beneficial owners of __% Notes other than yourself, you may either:

1. Complete and execute the __% Note Ballot (other than Items 2 and 3) and deliver to the beneficial owner such “prevalidated” __% Note Ballot, along with the Disclosure Statement and other materials requested to be forwarded. The beneficial owner should complete Items 2 and 3 of that Ballot and return the completed Ballot to [DEBTOR or DEBTOR’S AGENT] so as to be received before the Voting Deadline;

   OR

2. For any __% Note Ballots you do not “prevalidate”:

   Deliver the __% Note Ballot to the beneficial owner, along with the Disclosure Statement and other materials requested to be forwarded, and take the necessary actions to enable such beneficial owner to (i) complete and execute such Ballot voting to accept or reject the Plan, and (ii) return the complete, executed Ballot to you in sufficient time to enable you to complete the Master Ballot and deliver it to [DEBTOR or DEBTOR’S AGENT] before the Voting Deadline; and

With respect to all __% Note Ballots returned to you, you must properly complete the Master Ballot, as follows:

a. Check the appropriate box in Item 1 on the Master Ballot;

b. Indicate the votes to accept or reject the Plan in Item 2 of this Master Ballot, as transmitted to you by the beneficial owners of __% Notes. To identify such beneficial owners without disclosing their names, please use the customer account number assigned by you to each such beneficial owner, or if no such customer account number exists, please assign a number to each account (making sure to retain a separate list of each beneficial owner and the assigned number). IMPORTANT: BENEFICIAL OWNERS MAY NOT SPLIT THEIR VOTES. EACH BENEFICIAL OWNER MUST VOTE ALL HIS, HER, OR ITS __% NOTES EITHER TO ACCEPT OR REJECT THE PLAN. IF ANY BENEFICIAL OWNER HAS ATTEMPTED TO SPLIT SUCH VOTE, PLEASE CONTACT [DEBTOR or DEBTOR’S AGENT] IMMEDIATELY. Any Ballot or Master Ballot which is validly executed but which does not indicate acceptance or rejection of the Plan by the indicated beneficial owner or which impermissibly attempts to split a vote will not be counted;

c. Please note that Item 3 of this Master Ballot requests that you transcribe the information provided by each beneficial owner from Item 3 of each completed __% Note Ballot relating to other __% Notes voted;

d. Review the certification in Item 4 of the Master Ballot;

e. Sign and date the Master Ballot, and provide the remaining information requested;
f. If additional space is required to respond to any item on the Master Ballot, please use additional sheets of paper clearly marked to indicate the applicable item of the Master Ballot to which you are responding;

g. Contact [DEBTOR or DEBTOR’S AGENT] to arrange for delivery of the completed Master Ballot to its offices; and

h. Deliver the completed, executed Master Ballot so that it is actually received by [DEBTOR or DEBTOR’S AGENT] on or before the Voting Deadline. For each completed, executed __% Note Ballot returned to you by a beneficial owner, either forward such Ballot (along with your Master Ballot) to [DEBTOR or DEBTOR’S AGENT] or retain such __% Note Ballot in your files for one year from the Voting Deadline.

PLEASE NOTE:

This Master Ballot is not a letter of transmittal and may not be used for any purpose other than to cast votes to accept or reject the Plan. Holders should not surrender, at this time, certificates representing their securities. [DEBTOR or DEBTOR’S AGENT] will not accept delivery of any such certificates surrendered together with this Master Ballot. Surrender of securities for exchange may only be made by you, and will only be accepted pursuant to a letter of transmittal which will be furnished to you by the Debtor following confirmation of the Plan by the United States Bankruptcy Court.

No Ballot or Master Ballot shall constitute or be deemed a proof of claim or equity interest or an assertion of a claim or equity interest.

No fees or commissions or other remuneration will be payable to any broker, dealer, or other person for soliciting votes on the Plan. [We will, however, upon request, reimburse you for customary mailing and handling expenses incurred by you in forwarding the Ballots and other enclosed materials to the beneficial owners of __% Notes held by you as a nominee or in a fiduciary capacity. We will also pay all transfer taxes, if any, applicable to the transfer and exchange of your securities pursuant to and following confirmation of the Plan.]

NOTHING CONTAINED HEREIN OR IN THE ENCLOSED DOCUMENTS SHALL RENDER YOU OR ANY OTHER PERSON THE AGENT OF THE DEBTOR [OR THE DEBTOR’S AGENT], OR AUTHORIZE YOU OR ANY OTHER PERSON TO USE ANY DOCUMENT OR MAKE ANY STATEMENTS ON BEHALF OF ANY OF THEM WITH RESPECT TO THE PLAN, EXCEPT FOR THE STATEMENTS CONTAINED IN THE ENCLOSED DOCUMENTS.
IF YOU HAVE ANY QUESTIONS REGARDING THIS MASTER BALLOT OR THE VOTING PROCEDURES, OR IF YOU NEED ADDITIONAL COPIES OF THE MASTER BALLOT, BALLOTS, DISCLOSURE STATEMENT, OR OTHER RELATED MATERIALS, PLEASE CALL [DEBTOR or DEBTOR'S AGENT], AT ________.
EXHIBIT “D”

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re: Chapter 11 Case No.

[NAME], Debtors. Tax ID No.

[DEBTOR’S ADDRESS] Tax ID No.

SUMMARY OF PLAN OF REORGANIZATION AND NOTICE OF HEARING
TO CONSIDER (i) DEBTOR’S COMPLIANCE WITH DISCLOSURE
REQUIREMENTS AND (ii) CONFIRMATION OF PLAN OF REORGANIZATION

NOTICE IS HEREBY GIVEN as follows:

1. On (the “Petition Date”), [NAME OF DEBTOR], the above-captioned debtor (the “Debtor”), filed with the United States Bankruptcy Court for the Southern District of New York (the “Bankruptcy Court”) a proposed plan of reorganization (the “Plan”) and a proposed disclosure statement (the “Disclosure Statement”) pursuant to §§ 1125 and 1126(b) of title 11 of the United States Code (the “Bankruptcy Code”). Copies of the Plan and the Disclosure Statement may be obtained upon request of Debtor’s counsel at the address specified below and are on file with the Clerk of the Bankruptcy Court, [ADDRESS], where they are available for review between the hours of 9:00 a.m. – 4:30 p.m. The Plan and Disclosure Statement also are available for inspection on the Bankruptcy Court’s internet site at www.nysb.uscourts.gov.

Summary of Plan of Reorganization

2. [Provide one paragraph general description of salient Plan provisions, including whether proponent requests confirmation pursuant to 11 U.S.C. § 1129(b).] Votes on the Plan were solicited prior to the Petition Date.

The following chart summarizes the treatment provided by the Plan to each class of claims and interests and indicates the acceptance or rejection of the Plan by each class entitled to vote.

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<th>CLASS</th>
<th>CLASS DESCRIPTION</th>
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Hearing to Consider Compliance with Disclosure Requirements

3. A hearing to consider compliance with the disclosure requirements, any objections to the Disclosure Statement, and any other matter that may properly come before the Bankruptcy Court will be held before the Honorable , United States Bankruptcy Judge, in Room of the United States Bankruptcy Court.
Court, [ADDRESS], on _______________ at ___ m. or as soon thereafter as counsel may be heard (the “Disclosure Compliance Hearing”). The Disclosure Compliance Hearing may be adjourned from time to time without further notice other than an announcement of the adjourned date or dates at the Disclosure Compliance Hearing or at an adjourned Disclosure Compliance Hearing and will be available on the electronic case filing docket.

4. Any objections to the Disclosure Statement shall be in writing, shall conform to the Federal Rules of Bankruptcy Procedure and the Local Rules of the Bankruptcy Court, shall set forth the name of the objector, the nature and amount of any claims or interests held or asserted by the objector against the estate or property of the Debtor, the basis for the objection, and the specific grounds therefor, and shall be filed with the Bankruptcy Court at the address specified in the previous paragraph, with a copy delivered directly to Chambers, together with proof of service thereof, and served upon the following persons so as to be received on or before ____________, at 5:00 p.m. (Eastern Time):

(i) [NAME AND ADDRESS OF DEBTOR’S COUNSEL]

(ii) [NAME AND ADDRESS OF COMMITTEE COUNSEL]

(iii) [NAME AND ADDRESS OF BANK COUNSEL]

(iv) [NAME AND ADDRESS OF INDENTURE TRUSTEE]

(v) OFFICE OF THE UNITED STATES TRUSTEE

33 Whitehall Street, 21st Floor
New York, NY 10004
Attn: Carolyn S. Schwartz, Esq.

[vii] SECURITIES AND EXCHANGE COMMISSION

7 World Trade Center
New York, NY 10048
Attn: Nathan M. Fuchs, Esq.

[AND IF APPLICABLE:]

(vi) OFFICE OF THE UNITED STATES ATTORNEY FOR THE SOUTHERN DISTRICT OF NEW YORK

One St. Andrew’s Plaza
New York, NY 10007
Attn: Mary Jo White, Esq.

UNLESS AN OBJECTION IS TIMELY SERVED AND FILED IN ACCORDANCE WITH THIS NOTICE, IT MAY NOT BE CONSIDERED BY THE BANKRUPTCY COURT.

Hearing on Confirmation of the Plan

5. A hearing to consider confirmation of the Plan, any objections thereto, and any other matter that may properly come before the Bankruptcy Court shall be held before the Honorable ______________, United States Bankruptcy Judge, in Room ___ of the United States Bankruptcy Court, [ADDRESS], immediately following the Disclosure Compliance Hearing referred to above or at such later time as determined by the Bankruptcy Court at the conclusion of the Disclosure Compliance Hearing (the “Confirmation Hearing”). The Confirmation Hearing may be adjourned from time to time without further notice other than an announcement of the adjourned date or dates at the Confirmation Hearing or at an adjourned Confirmation Hearing.

6. Objections to the Plan, if any, shall be in writing, shall conform to the Federal Rules of Bankruptcy Procedure and the Local Rules of the Bankruptcy Court, shall set forth the name of the objector, the nature and amount of any claims or interests held or asserted by the objector against the estate or property of the Debtor, the basis for the objection, and the specific grounds therefor, and shall be filed with the Bankruptcy Court at the address specified in the previous paragraph, with a copy delivered directly to Chambers, together with proof of service.
thereof, and served upon the persons set forth in paragraph 4 above so as to be received on or before __________, at 5:00 p.m. (Eastern Time). UNLESS AN OBJECTION IS TIMELY SERVED AND FILED IN ACCORDANCE WITH THIS NOTICE, IT MAY NOT BE CONSIDERED BY THE BANKRUPTCY COURT.

7. The times fixed for the Confirmation Hearing and objections to confirmation of the Plan may be rescheduled by the Bankruptcy Court in the event that the Bankruptcy Court does not find compliance with the disclosure requirements on __________. Notice of the rescheduled date or dates, if any, will be provided by an announcement at the Disclosure Compliance Hearing or at an adjourned Disclosure Compliance Hearing and will be available on the electronic case filing docket.

Section 341(a) Meeting

8. A meeting pursuant to section 341(a) of the Bankruptcy Code (the “Section 341(a) Meeting”) shall be held at the United States Bankruptcy Court, in room __________, [ADDRESS], on __________, at __________, m. Such meeting will not be convened if (i) the Plan is confirmed prior to the date set forth above for the Section 341(a) Meeting and (ii) the order confirming the Plan (or order entered substantially contemporaneously therewith) contains a provision waiving the convening of a Section 341(a) Meeting.

Dated: New York, New York

________________________
[NAME, ADDRESS, AND
TELEPHONE NUMBER OF
DEBTOR’S COUNSEL]

BY ORDER OF THE COURT

________________________
United States Bankruptcy Judge
CHAPTER 20
CONFIRMATION IS NOT THE END OF THE CASE

The Day After

Along with the date the court approves a debtor’s plan of reorganization (the date of confirmation), a date must be scheduled in which the provisions of the plan actually go into effect. This date when the confirmed plan takes effect is known as the “Effective Date.” Case law differs as to the timing of the Effective Date as it relates to the Date of Confirmation.

In support of the proposition that the effective date should be reasonably close to the confirmation date, one court held that “[t]he effective date of the plan is expressly designated as the critical point for the major financial standards for confirmation. The valuations required by these sections are likely to be less accurate if the effective date is not close to the date of the hearing on confirmation.” *In re Jones*, 32 B.R. at 958 n.13 (Utah 1983). On the other hand, effective dates have been set three, six, or more months after confirmation—some have been set with reference to some fact, such as the debtor’s obtaining exit financing or amassing sufficient funds to pay administrative claims.

Discharge

Bankruptcy Code §1141(c) states:

Except as provided in subsections (d)(2) and (d)(3) of this section and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan, is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor.

Thus, the general rule is that confirmation discharges any lien securing a claim, whether or not the lien is challenged by the debtor or treated by the plan, unless the plan or confirmation order provides otherwise. This conflicts with case law providing that liens ride through bankruptcy if they are not affirmatively dealt with in the case. The solution to this uncertainty is to provide for treatment, discharge or ride through, with a catchall provision in the plan or order confirming the plan.

Bankruptcy Code §1141(d) provides:

Except as otherwise provided in this subsection, in the plan, or in the order confirming the plan, the confirmation of a plan:

(A) discharges the debtor from any debt that arose before the date of such confirmation, and any debt of a kind specified in §502(g), 502(h), or 502(i) of this title, whether or not:
(i) a proof of the claim based on such debt is filed under §501 of this title;

(ii) such claim is allowed under §502 of this title; or

(iii) the holder of such claim has accepted the plan; and

(B) terminates all rights and interests of equity security holders and general partners provided by the plan.

Thus, under the terms of the statute, the debtor is discharged from both pre-petition and post-petition pre-confirmation debts. However, the discharge does not necessarily terminate a pre-petition debt for all purposes. Rather, the discharge is better understood as an injunction preventing collection on claims other than in accordance with the terms of the plan.

Only debtors that reorganize in chapter 11 and remain in business receive a discharge. There is no discharge for debtors that liquidate in chapter 11.

Bankruptcy Code §1141(d)(2) provides that confirmation does not effect a discharge of individual debtors who would not be permitted a discharge under §523. This means that if an individual debtor has debts that would be nondischargeable in a chapter 7 case, they will also be nondischargeable in a chapter 11. In addition, while a business debtor’s discharge is effective upon confirmation, an individual debtor’s chapter 11 discharge must await completion of plan payments, unless the court orders otherwise.

Res Judicata Effect of the Plan

A plan of reorganization that has been confirmed by a final order of the bankruptcy court is res judicata as to the matters it addresses, so long as its confirmation was not obtained by fraud or by the denial of due process. The res judicata effect of a final confirmation order, which has been described as equivalent to that of a judgment rendered on the merits by a federal district court, bars any collateral attack on the plan, its confirmation, or the reorganization process it ordains. Therefore, only a direct attack, such as an objection to confirmation or appeal of the confirmation order, is available to defeat confirmation.

What Happens to the Debtor’s Assets?

Once the debtor enters the post-confirmation stage of its life cycle, it regains control of its assets without many of the regulations that existed during the bankruptcy. Unless those rights are vested somewhere else by the confirmed plan, the debtor may use or dispose of its property without the court approval that was required during the bankruptcy. As stated in the Bankruptcy Code, “Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.” See §1141(c).
Liquidating Trusts

A liquidating trust (sometimes also known as a litigation trust or a post-confirmation estate) is often created in a post confirmation estate for the purpose of litigating unresolved claims. This practice finds its authority in §1123(b)(3) of the Bankruptcy Code, which provides that the contents of a plan may provide for: settlement or adjustment of any claim or interest belonging to the debtor or to the estate; or the retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest.

The Reorganized Debtor

In many aspects in the post confirmation period business for the debtor will return to normal. The debtor is free to enter into agreements, borrow money, buy and sell assets all without court approval. The UST and the court take a far reduced role in monitoring the debtor, and instead rely on creditors, interest holders, and often the debtor itself to carry out implementation of the confirmed plan. The philosophy of the Bankruptcy Code is that during the bankruptcy, the court will provide shelter to the debtor, but this changes at plan confirmation. Post confirmation the debtor is removed from “the ‘tutelage’ status…which may limit and hamper [the corporation’s] activities and throw doubt upon its responsibility.” In re Shuman, 277 B.R. 638, 652 (E.D. Penn. 2001). The debtor still has a duty to follow the confirmed plan and comply with any orders issued during the bankruptcy. These duties vary depending on the circumstances of the bankruptcy, but typically include distributing funds, securities or property to holders of allowed claims and interests.

What Happens to the Estate?

Though the debtor is now existing in a post confirmation ‘business as normal state,’ the case will continue for some time while the court rules on various post confirmation matters, which may include claim objections, avoidance actions, and sometimes disputes regarding interpretation or implementation of the plan. The bankruptcy does not officially end until a final order closing the case is entered by the court. Depending on the size of the estate, the number of claims filed, the complexities of the claims and defenses, and the court’s docket is sometimes several years or more before this final decree is entered. Although the ‘estate’ ceases to exist once the plan is confirmed, the final order ending the matter will still need to be entered before the matter is considered closed.

The Bankruptcy Court’s Continuing Jurisdiction

With the debtor existing in a post confirmation state and the court adjudicating matters related to the bankruptcy, questions arise regarding the scope of jurisdiction that remains with the bankruptcy court. The bankruptcy code doesn’t put a limit on the post confirmation jurisdiction of the court, but §1142 does outline how the court’s jurisdiction begins to weaken.
Implementation of Plan

Notwithstanding any otherwise applicable nonbankruptcy law, rule, or regulation relating to financial condition, the debtor and any entity organized or to be organized for the purpose of carrying out the plan shall carry out the plan and shall comply with any orders of the court.

The court may direct the debtor and any other necessary party to execute or deliver or to join in the execution or delivery of any instrument required to effect a transfer of property dealt with by a confirmed plan, and to perform any other act, including the satisfaction of any lien, that is necessary for the consummation of the plan.

The bankruptcy court’s jurisdiction is further diminished upon “substantial consummation” of a plan pursuant to §1101(2).

Varying interpretations of the scope of post-confirmation jurisdiction has led to language commonly being added to plans and confirmation orders stating specific retention-of-jurisdiction provisions, the idea being this language will decrease the likelihood of a nonbankruptcy court misinterpreting or incorrectly enforcing a provision of the plan.

The confirmed plan has the effect of creating a contract between the debtor and its creditors, while simultaneously lifting the automatic stay. This situation creates concurrent jurisdiction between the bankruptcy and the nonbankruptcy courts. Hence the effort by plan proponents to include broad retention of jurisdiction provisions in the plan or confirmation order to ensure jurisdiction exclusivity (where possible) remaining with the bankruptcy court. At the same time, “a court “cannot write its own jurisdictional ticket” by seeking to retain jurisdiction where none exists.” See Diagnostics International Inc. v. Aerobic Life Products Co. (In re Diagnostics International Inc.), 257 B.R. 511 (Bankr. D. ____).

Consequently, regardless of its intended scope and breadth, a retention of jurisdiction provision cannot create post-confirmation jurisdiction in a bankruptcy court beyond the limited circumstances where such jurisdiction would otherwise exist.

A Final End to the Bankruptcy

In the eyes of the bankruptcy court, the debtor ends its post confirmation life in several ways. Ideally, the end comes after the estate has been fully administered and the Court enters an ‘Order For Final Decree’ pursuant to the Bankruptcy Rule 3022. It is not necessary to leave the case open until the plan is fully consummated; most plans provide that that the case can be reopened for cause shown. Importantly, U.S. Trustee fees remain payable as long as a case is open.

If circumstances arise where the reorganized debtor is unable to implement aspects of the confirmed plan and a default occurs, several options exist: (1) it might try continuing to perform and try to cure the default; (2) it might voluntarily convert the case to chapter 7 to permit an orderly disposition of its assets; (3) it might commence a new bankruptcy case to reorganize or liquidate; and (4) it might seek to modify its existing plan.
APPENDIX 20(a)
IN RE ENCOMPASS SERVICES

MEMORANDUM OPINION ON ASA’S MOTION
(i) TO ABSTAIN, OR ALTERNATIVELY
(ii) FOR DISMISSAL OR SUMMARY JUDGMENT

I. Introduction

This adversary proceeding presents an interesting attempt at using the Bankruptcy Code as a mechanism for forum shopping. In 2001, the plaintiff, Gilbane Building Company (Gilbane), entered into a contract with Air Systems Incorporated (ASI), which at the time was a wholly owned subsidiary of Encompass Services Corporation (Encompass or the Debtor). In late 2002, Encompass and ASI filed for Chapter 11. As part of the reorganization, Air Systems Acquisitions, Inc. (ASA) purchased all the assets of ASI, including assignments of the executory contracts, and this purchase was incorporated into the confirmed plan. In November 2003, after completion of the contract at issue, ASA sued Gilbane for breach of contract and other contractual claims in California state court. In that suit, the court granted a motion for summary judgment in favor of ASA after sanctioning Gilbane for discovery abuse. Gilbane has appealed this judgment. Meanwhile, in its capacity as plaintiff in this adversary proceeding, Gilbane has raised in this Court many of the same issues presented in its losing effort in the California suit.

Concurrent with Gilbane’s appeal of the California trial court decision, Gilbane is attempting to have this Court review the validity of the assignment of the executory contract under Encompass’s confirmed plan. ASA has questioned whether this Court has jurisdiction over this adversary proceeding. This Court finds that it does not have post-confirmation jurisdiction over this proceeding. Further, even if post-confirmation jurisdiction does exist, it is appropriate for this Court to permissively abstain from hearing this proceeding. The purpose of this Memorandum Opinion is to set forth how the Court has arrived at this decision.

II. Findings of Fact

The facts, either as stipulated to or admitted by counsel of record, or as determined from the record, in chronological order, are as follows:

1. On or about August 8, 2001, ASI entered into a contract with Gilbane to provide HVAC and mechanical services work at the Mission Bay Building at the University of California San Francisco (the “Subcontract”). Gilbane was the general contractor on the project and ASI was one of the subcontractors. (Declaration of Art Williams in Support of ASA’s Summary Disposition Motion, Adversary Docket No. 40, Appendix A at ¶ 7). The contract contains a provision
prohibiting ASI from assigning the contract without written consent from Gilbane. (Id. at Exhibit 1, ¶ 9.9).

2. On Nov. 19, 2002, Encompass and its subsidiaries, including ASI, filed for Chapter 11 in the Southern District of Texas.


4. On Feb. 24, 2003, ASA sent a letter to Scott Chilcote, Gilbane’s project executive at the Mission Bay Building site, notifying him about the pending approval of the sale of ASI to ASA. (Declaration of Art Williams, supra, Exhibit 2).

5. On March 17, 2003, this Court approved the Purchase and Sale Agreement (“PSA”) entered into among ASI, Encompass, and ASA. (Docket No. 1836). The PSA included a term prohibiting the transfer of assets not freely transferable without the consent of a third party. (Docket No. 1936, Exhibit A, at §1.8). The transaction was completed the next day on March 18, 2003. (Declaration of Art Williams, supra, at ¶ 12). Thereafter, ASA performed under the Subcontract. (Id. at ¶ 14).

6. On May 23, 2003, this Court confirmed the Debtor’s Second Amended Joint Plan of Reorganization of Encompass Services Corporation and Its Affiliated Debtors under Chapter 11 of the Bankruptcy Code (the “Plan” or the “Confirmed Plan”). (Docket No. 2072).

7. In the latter part of 2003, the Subcontract was completed. (Declaration of Art Williams, supra, at ¶ 17).

8. On Nov. 7, 2003, ASA filed suit against Gilbane in the Superior Court of California, County of San Francisco. This suit is styled Air Sys. Acquisition, Inc. v. Gilbane Bldg Co., Case No. CGC-03-426218. ASA sought damages that it claimed Gilbane owed under the Subcontract. (Declaration of Gretchen E. Dent in Support of ASA’s Summary Disposition Motion, at ¶ 2).

9. On March 30, 2005, the California state court sanctioned Gilbane with both evidentiary and monetary sanctions for discovery abuse. (Id. at Exhibit 2). This order prevented Gilbane from adducing evidence relating to the Interrogatories, Requests for Admissions, and Request for Production to which it failed to respond. (Id.)

10. On June 3, 2005, Gilbane submitted to the California court its (and co-defendant, Traveler’s Insurance’s) Joint Supplemental Opposition to ASA’s Motion for Summary Judgment/Adjudication. This response argued that Gilbane failed to give consent to the assignment in writing and that the bankruptcy estates of ASA and Encompass could not have “validly assigned the subcontract without Gilbane’s prior written consent because the Air Systems Bankruptcy Estate
(a) did not assume the subcontract; and (b) ASI did not provide adequate assurance of future performance, both of which are mandatory under §365(f) of the United States Bankruptcy Code.” (Declaration of Gretchen E. Dent, Exhibit 3 at 2:8-18).

11. On June 10, 2005, Gilbane initiated this adversary proceeding. (Adversary Docket No. 1). Gilbane’s initial complaint named as defendants ASA, Encompass Holding, Todd A. Matherne (the Dispersing Agent appointed to the main bankruptcy case), and the Board of Regents of the University of California. All defendants except ASA were dismissed from the suit on July 28, 2005. (Adversary Docket No. 24). In its complaint, Gilbane argues that ASA has no standing to sue because the assignment from Encompass/ASI was invalid. Gilbane also asserts that this Court has post-confirmation jurisdiction over the claims which Gilbane asserts. As relief, Gilbane seeks (i) a declaration that the assignment was invalid; (ii) a declaration that the Subcontract remains in the Debtor’s estate; and (iii) an injunction against ASA from further prosecuting the Subcontract claims in California state court. (Adversary Docket No. 1).

12. On Sept. 26, 2005, Gilbane moved for summary judgment against ASA in the present proceeding. (Adversary Docket No. 38). On the same day, ASA filed a Motion to (i) Abstain, or alternatively (ii) for Dismissal or Summary Judgment. (Adversary Docket No. 40). Both parties thoroughly briefed the issues raised in these motions, including the jurisdictional issue.

13. On Oct. 6, 2005, a hearing was held on the competing Motions for Summary Judgment and Motion for Abstention. The jurisdictional issues were extensively argued, and this Court requested further briefing on certain issues raised at the hearing. The Court took the matter under advisement pending the additional briefing to be done.

14. On Nov. 16, 2005, this Court issued its ruling orally from the bench.

III. Conclusions of Law Regarding Jurisdiction

Gilbane strenuously argues that this Court has subject matter jurisdiction over this post-confirmation suit because (a) it is a core proceeding; (b) it relates to pre-confirmation orders; and (c) it concerns rights arising from Bankruptcy Rule 6006 and §365 of the Bankruptcy Code. Gilbane has also argued that this Court has exclusive jurisdiction because these issues relate to the clarification of one of its own orders, namely the Sale Order that approved the PSA, which was incorporated by reference into the Confirmed Plan. ASA argues that this Court does not have jurisdiction over this dispute or, alternatively, even if it does, it should abstain.

A. Congressional Authorization of Bankruptcy Jurisdiction

Bankruptcy courts are courts of limited jurisdiction, only having the authority to hear that class of cases “‘endowed [upon them] by the Constitution and... conferred by Congress.’ “ In re Kevco, Inc., 309 B.R. 458, 464 (Bankr. N.D. Tex.2004) (quoting Epps v. Bexar-Medina-
Appendix 20(a) - In re Encompass
Services

Atascosa Counties Water Improvement Dist. No. 1, 665 F.2d 594, 595 (5th Cir. 1982)). Because bankruptcy judges are non-Article III judges, they are only permitted to hear that class of cases which Congress has determined the district courts may assign to them. See, e.g., Things Remembered, Inc. v. Petrarca, 516 U.S. 124, 132 n. 2, 116 S.Ct. 494, 133 L.Ed.2d 461 (1995) (Ginsburg, J., concurring). Congress has endowed the district courts with “original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11.” 28 U.S.C. §1334(b). This congressional mandate provides the district courts with jurisdiction over four types of bankruptcy matters: “(1) ‘cases under title 11,’ (2) ‘proceedings arising under title 11,’ (3) proceedings ‘arising in’ a case under title 11, and (4) proceedings ‘related to’ a case under title 11.” U.S. Brass Corp. v. Travelers, Ins. Group (In re U.S. Brass Corp.), 301 F.3d 296, 303 (5th Cir.2002) (quoting §§28 U.S.C. 1334(a)-(b)). The Fifth Circuit has described these four classes of cases as the jurisdictional boundaries drawn around the bankruptcy courts. See id. at 304.

The district courts are authorized to refer to the bankruptcy courts for adjudication of “any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11...” 28 U.S.C. §157(a). “Cases under title 11” refers to the bankruptcy case itself, with all other proceedings emanating from the case either “arising under,” “arising in,” or “related to.” In re U.S. Brass Corp., 301 F.3d at 304. By way of one example only, an adversary proceeding to recover preferences under 11 U.S.C. §547 is a proceeding arising under title 11. See Celotex Corp. v. Edwards, 514 U.S. 300, 325 n. 13, 115 S.Ct. 1493, 131 L.Ed.2d 403 (1995) (Stevens, J. dissenting). In order to have jurisdiction, a bankruptcy court must determine that a case is at least “related to” a bankruptcy proceeding. In re Brass Corp., 301 F.3d at 304. To make this determination, the court must look to 28 U.S.C. §157(b)(1), which delineates the exact scope of the bankruptcy court’s jurisdiction. Section 157(b)(1) gives bankruptcy courts the power to “hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11...”

Based on this language, courts have determined that a non-core proceeding is equated with a proceeding that is “related to” the underlying bankruptcy case. See In re Stonebridge Tech., Inc., 430 F.3d 260, 266 (5th Cir. 2005). Non-core proceedings may be heard by the bankruptcy judge, but any findings of fact and conclusions of law proposed by the bankruptcy judge must be submitted to the district court for entry of a final order or judgment. 28 U.S.C. §157(c)(1). The Fifth Circuit has held that “§157 equates core proceedings with the categories of ‘arising under’ and ‘arising in’ proceedings; therefore, a ‘proceeding is core under §157 if it invokes a substantive right provided by title 11 or if it is a proceeding that, by its nature, could arise only in the context of a bankruptcy case.’” In re U.S. Brass Corp., 301 F.3d at 304 (quoting In re Wood, 825 F.2d 90, 97 (5th Cir.1987)).

B. The Present Adversary Proceeding is a Non-Core Proceeding

As a preliminary matter, because this determination has bearing on both the jurisdictional determination and permissive abstention, this Court will address whether the adversary proceeding at bar is core or non-core. Gilbane has argued that this is a core proceeding pursuant to 28 U.S.C. §157(b)(2)(A), (E), (L) and (O). The relevant sections state:
Core proceedings include, but are not limited to

(A) matters concerning the administration of the estate; ...

(E) orders to turn over property of the estate; ...

(L) confirmations of plans; ...

(O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship....

Gilbane mistakenly characterizes this proceeding as an action affecting the estate. It is well established in the Fifth Circuit, and many other circuits, that once the plan of reorganization has been confirmed, the estate ceases to exist. In re U.S. Brass, 301 F.3d at 304; Bank of Louisiana v. Craig’s Stores of Tex., Inc. (In re Craig’s Stores of Texas, Inc.), 266 F.3d 388, 390 (5th Cir. 2001) (citing In re Fairfield Cmtys. Inc., 142 F.3d 1093, 1095 (8th Cir. 1998)); (In re Johns-Manville Corp., 7 F.3d 32, 34 (2d Cir. 1993)); In re Enron Corp. Sec., Derivative & ERISA Litig., 2005 WL 1745471 (S.D.Tex. 2005) (hereinafter In re Enron). Without an estate to administer or to which to return assets, this Court can hardly determine the suit at bar to be a core proceeding under §157(b)(2)(A) and (E), or under the provision in (O) that gives core status to “proceedings affecting the liquidation of the assets of the estate....” The remainder of §157(b)(2)(O), which concerns “proceedings affecting ... the adjustment of the debtor-creditor ... relationship,” is inapplicable to this proceeding as well. The dispute between Gilbane and ASA has relatively nothing to do with Encompass and its subsidiaries, as neither party to this suit is involved in the underlying bankruptcy as either a debtor or a creditor.

The key issues in the suit at bar do involve an aspect of the Confirmed Plan, which lends support to the argument that this dispute is a core proceeding under §157(b)(2)(L). However, this Court’s determination will not have a substantial impact on a plan that Encompass, as a reorganized debtor, has been operating under for the last two years. The issue at bar can be distinguished from In re Case, 937 F.2d 1014 (5th Cir. 1991), in which the Fifth Circuit found that a breach of contract claim on a note executed as part of a settlement agreement incorporated into the debtor’s plan of reorganization was a core proceeding under §157(b)(2). Id. at 1017. There, the court found that the promissory note and settlement agreement were not independent from the bankruptcy; they were an integral part of formulating an acceptable plan of reorganization. Id. at 1019-20. The court also found that the debtor’s attempt to satisfy the terms of the promissory note by providing services in lieu of cash was an alteration of the express terms of the plan and therefore would have constituted an “‘adjustment of the debtor-creditor relationship under §157(b)(2)(O).’” Id. at 1020. Conversely, in the present proceeding, the Subcontract was independent from the underlying bankruptcy, and voiding the assignment of the Subcontract would not substantially modify the express terms of the Confirmed Plan such that the debtor-creditor relationship would be affected. Therefore, this Court finds that this proceeding is non-core under 28 U.S.C. §157. Because it is non-core, this suit can only be a “related to” proceeding.
C. Framework for “Related to” Jurisdiction

Bankruptcy courts may retain jurisdiction to hear a proceeding that is related to a bankruptcy case. 28 U.S.C. §157(e). The Congressional grant of jurisdiction found in 28 U.S.C. §1334 does not limit bankruptcy jurisdiction to pre-confirmation issues. Most circuits generally agree that “related to” jurisdiction for post-confirmation disputes is warranted when the outcome of the suit could have any conceivable effect on the administration of the estate in bankruptcy. In re Stonebridge Tech., Inc., 430 F.3d at 266 (citing In re Wood, 825 F.2d 90, 93 (5th Cir. 1987)). The Second Circuit adopted a slightly different test in In re Turner, using a “significant connection” theory of relatedness. In re Turner, 724 F.2d 338, 341 (2d Cir.1983).

In recent years, the Fifth Circuit has adopted a more exacting view of “related to” jurisdiction, focusing on the debtor’s emergence from bankruptcy protection. In re Craig’s Stores, 266 F.3d at 390. In In re Craig’s Stores, the court noted that upon confirmation of the plan, the debtor’s estate, and therefore the bankruptcy court’s jurisdiction, ceases to exist. Id. Under this view, the bankruptcy court tosses the newly reorganized debtor out of the warmth of the “‘protective wraps’” of bankruptcy into the “‘cold, cruel business world....’” Id. at 390-91. In In re U.S. Brass Corp., the Fifth Circuit added specificity to its ruling in In re Craig’s Stores by holding that a bankruptcy court does indeed have post-confirmation jurisdiction, but only for disputes concerning the implementation or execution of a confirmed plan pursuant to 28 U.S.C. §1142(b) or over core proceedings under §157. 301 F.3d at 304-06

In re Coho Energy, Inc., 309 B.R. 217 (Bankr. N.D. Tex.2004) highlighted several important factors from the combined opinions of In re Craig’s Stores and In re U.S. Brass Corp. See 309 B.R. at 220-21. In In re Coho Energy, Inc., the debtor filed an adversary proceeding against several defendants for breach of contract, an accounting of expenses, and several other state law claims that arose out of violations of operating agreements and other agreements incorporated into the plan of reorganization. Id. at 218-19. The plan contained a provision that the estate’s causes of actions would vest in a liquidating trust for the benefit of and distribution to creditors of the estate. Id. at 218. The defendants challenged the bankruptcy court’s subject matter jurisdiction on the basis that the proceeding was filed after confirmation of the plan. Id. at 219. The Coho court found that subject matter jurisdiction did remain in the bankruptcy court on the basis that the claims arose pre-petition, the plan incorporated the prosecution of the claims, and the plan also provided that any proceeds received would be distributed to the creditors under the provisions of the plan-thus impacting compliance with the plan. Id. at 221; cf. In re U.S. Brass Corp., 301 F.3d at 301-03 (where the claims at issue arose pre-petition, the plan incorporated provisions for resolution of the claim and distribution of any recovery, and amendments to this procedure would impact the full consummation of the plan). See also In re Enron, 2005 WL 1745471.

Based on the Fifth Circuit decisions and the case law applying those rulings, this Court has identified six pertinent factors for a post-confirmation subject matter jurisdiction inquiry: (1) when the claim at issue arose; (2) what provisions in the confirmed plan exist for resolving disputes and whether there are provisions in the plan retaining jurisdiction for trying these suits; (3) whether the plan has been substantially consummated; (4) the nature of the parties involved; (5) whether state law or bankruptcy law applies; and (6) indices of forum shopping.
D. Application of the Six Factors to the Present Adversary Proceeding

1. When the Claim at Issue Arose.

Many of the cases analyzing post-confirmation jurisdiction have found that when the claim arose pre-petition, the court retains jurisdiction, particularly when the claim has been incorporated in the plan of reorganization. *In re Coho Energy, Inc.*, 309 B.R. at 221; *In re U.S. Brass Corp.*, 301 F.3d at 299-300. In *In re Craig’s Stores*, where the court found that it did not have post-confirmation jurisdiction, the claim at issue arose post-petition and post-confirmation out of a contract that was entered into between the parties pre-petition. 266 F.3d at 391. Actual litigation, or at least antagonism between the parties, must be present on the petition date for the court to assert jurisdiction. See id.

The present adversary proceeding between Gilbane and ASA is more analogous to *In re Craig’s Stores* than to *In re Coho Energy, Inc.* or *In re U.S. Brass Corp.* The Subcontract was in existence in the same or substantially similar form pre-petition. See *In re Craig’s Stores*, 266 F.3d at 391. Gilbane argues that ASA’s submission of an Extra Work Claim one month before the Chapter 11 petition was filed is sufficient to show antagonism between the parties. This Court disagrees. The Extra Work Claim was simply a claim for payment submitted between two contracting parties, whereas the claims at issue in *In re U.S. Brass* and *In re Coho Energy, Inc.* had both accelerated to the point of near litigation before the bankruptcy petition was filed. *In re Coho Energy, Inc.*, 309 B.R. at 221 (noting that while the claims were not formally asserted pre-petition, they were preserved under the Plan); See *In re U.S. Brass Corp.*, 301 F.3d at 300 (reciting the plaintiff/debtor’s argument that “the insurers (defendants) unwillingness to defend or provide coverage for the lawsuits caused the company to file for bankruptcy protection”). Accordingly, this first factor points to a finding of no jurisdiction.


There are several provisions in a confirmed plan that must be examined to determine whether this factor supports a finding of post-confirmation jurisdiction. A court must examine the retention of jurisdiction language contained in the plan, the disputed provisions in the Plan itself, and the facts or law deriving from the plan.

(i) Retention of jurisdiction

The retention of jurisdiction provisions are one important factor preserving a bankruptcy court’s post-confirmation jurisdiction. *In re Enron*, 2005 WL 1745471, at *5. A plan may not confer jurisdiction absent statutory authority. *In re U.S. Brass, Corp.*, 301 F.3d at 303. “While a plan may not confer or expand subject matter jurisdiction, some courts find a retention of jurisdiction in the plan to be a prerequisite to post-confirmation jurisdiction. In other words, a plan which fails to retain subject matter jurisdiction may leave it lacking, but a plan cannot create jurisdiction where it does not otherwise exist.” *In re Coho Energy, Inc.*, 309 B.R. at 220 n. 4; cf. *In re U.S. Brass Corp.*, 301 F.3d at 303 (noting that the plan contained a broad retention of jurisdiction provision). The retention of jurisdiction language in the plan does not need to cover
the specific act at issue; however, it does need to be sufficiently broad to encompass potential post-confirmation proceedings. *In re Enron*, 2005 WL 1745471, at *5.

In the present case, the Debtor’s Confirmed Plan provides for retention of jurisdiction in Article XII. Article XII, §h gives this Court continuing jurisdiction to “hear and determine disputes arising in connection with the interpretation, implementation, consummation, or enforcement hereof, and all contracts, instruments, and other agreements executed in connection with this Plan.” The Confirmed Plan clearly provides for continuing jurisdiction over matters that pertain to the implementation of the contracts assumed by the Confirmed Plan. Thus, this language favors a finding that this Court has jurisdiction.

(ii) Language in the Plan

This adversary proceeding does not presently implicate implementation of the Confirmed Plan because the sale of ASI’s assets to ASA had already occurred and the Subcontract had already been completed pursuant to the Confirmed Plan. Neither party disputes that the subcontract has been performed. Gilbane is seeking a declaration that the “Subcontract was not sold to ASA and is held by Encompass Holding” based on the argument that the Subcontract could not be assumed under the express language of the PSA and the anti-assignment clause contained in the Subcontract. See Gilbane’s Complaint for Declaratory Judgment, ¶ 43. The most glaring problem with this argument is that the order issued by this Court confirming the Plan expressly states that “the Assigned Contracts shall, upon Assignment to the Buyer, be deemed to be valid and binding and in full force and effect enforceable in accordance with their terms notwithstanding any provision in any such Assigned Contract (including those of the type described in sections 365(b)(2) and (f) of the Bankruptcy Code) that prohibits, restricts or conditions such assignment or transfer and, pursuant to §365(k) of the Bankruptcy Code.” This is hardly the type of language that necessitates clarification by only a bankruptcy court. A state court of competent jurisdiction can just as easily interpret the impact of this language on the validity of the Subcontract. Thus, the language of the Confirmed Plan favors a holding that this Court has no jurisdiction over this adversary proceeding.

(iii) Facts and law arising from the plan

Both the facts and law implicated in this proceeding point to this Court not having continuing jurisdiction. *In re U.S. Brass Corp.*, 301 F.3d at 303; *See In re Craig’s Stores*, 266 F.3d at 391; *In re Kevco*, 309 B.R. at 464. A confirmed plan is a contract in its own right. *In re U.S. Brass Corp.*, 301 F.3d at 307; *In re Coho Energy Inc.*, 309 B.R. at 219. As such, it can be interpreted by any court of competent jurisdiction:

> [T]he basic theory of reorganization proceedings is that the debtor...has been rehabilitated by the plan so that it can carry on its business. The corollary of this is that [a reorganized debtor] and its creditors should work out their mutual rights and duties in the ordinary tribunals and should not forever continue under the tutelage of the bankruptcy court.

The facts underlying this proceeding were all asserted and determined by the California state court and are in the process of appeal in the California appellate court system.

The Subcontract that is the subject of this litigation was not created by the Confirmed Plan; the Plan merely incorporated assumption of the Subcontract authorized in the PSA. See Docket Nos. 1836 and 2072. There were no obligations between the Debtor and Gilbane, or between ASA and Gilbane, created by implementation of the Confirmed Plan-these obligations had already arisen pre-petition. See In re Craig’s Stores, 266 F.3d at 391 (determining no jurisdiction existed in part because the dispute did not arise as a result of “any obligation created by the debtor’s reorganization plan”). This claim also does not involve a trust created by the Confirmed Plan, which has been a factor supporting post confirmation jurisdiction. See In re U.S. Brass, Corp., 301 F.3d at 301 (proceeds from the underlying litigation would be paid over to a liquidating trust); In re Coho Energy, Inc., 309 B.R. at 221. In fact, Gilbane dropped as a party the Dispersing Agent, the closest entity to a litigating/liquidating trust, from this adversary proceeding shortly after it was filed. See Adversary Docket No. 24.

The effect of California law on the non-assignment clause in the contract between ASA and Gilbane is implicated in this matter. Although this fact is not dispositive, the Court may consider it in its determination of jurisdiction. Here, there is no question that California law plays a key role in determining the contractual dispute between the parties.

On balance, the provisions in the Confirmed Plan weigh more heavily in favor of a finding of no jurisdiction than a finding that this Court has jurisdiction.

3. Whether Substantial Consummation Has Occurred

An action impacting a confirmed, but not substantially consummated plan would have an impact on the debtor-creditor relationship, a factor which favors continuing jurisdiction. See In re Craig’s Stores, 266 F.3d at 391. In the case at bar, the Confirmed Plan was confirmed on May 28, 2003. The Notice of Occurrence of Effective Date, entered on June 10, 2003, stated that the Effective Date occurred on June 9, 2003. See Docket No. 2072 and 2570. Yet, this adversary proceeding was not commenced until June 10, 2005-more than two years after the Effective Date. There has been no allegation that the Confirmed Plan has not been substantially consummated under 11 U.S.C. §1101(2), and this Court is not going to assume that after a two-year span it has not. The impact on the post confirmation distributions to creditors is insufficient for a finding of continuing jurisdiction. See In re Craig’s Stores, 266 F.3d at 391. Therefore, this factor weighs against continuing jurisdiction.

Additionally, Gilbane’s requested relief would in effect return assets to Encompass’s estate—an entity which no longer exists. According to In re Craig’s Stores, the Debtor’s estate no longer exists after the confirmation of a plan. 266 F.3d at 390 (“After a debtor’s reorganization plan has been confirmed, the debtor’s estate, and thus bankruptcy jurisdiction, ceases to exist, other than for matters pertaining to the implementation or execution of the plan.”) (quoting In re Fairfield Communities, Inc., 142 F.3d 1093, 1095 (8th Cir.1998)). In the case at bar, there is no longer an estate of Encompass, as the Plan is confirmed and substantially consummated.
4. Parties Involved

Although it is true that litigation where the debtor is not a party can still constitute “related to” jurisdiction, such jurisdiction continues only if the suit has an impact on the bankruptcy estate. *In re Enron*, 2005 WL 1745471 at *4, n. 19. In the instant case, there is no estate left to be administered. *In re Craig’s Stores*, 266 F.3d at 390. The fact that the Confirmed Plan has been in effect for over two years, the Debtor’s estate has ceased to exist, and neither party is a debtor, supports a finding of no jurisdiction.

5. Whether State Law or Bankruptcy Law Applies

The PSA states that California law governs the agreement. The dispute over the PBA is between two non-debtor entities who have already litigated in the state court of California. While there are certainly bankruptcy issues involved, the fact is that a California court applying California law has issued a judgment. These circumstances weigh more heavily in favor of a finding of no jurisdiction rather than one of jurisdiction. Given the substantial time that the California courts have already spent adjudicating this dispute, they are more informed on the claims at issue in the assumed Subcontract.

6. Indices of Forum Shopping

Although this factor has not been mentioned in previous cases discussing whether a bankruptcy court has continuing “related to” jurisdiction, in the present proceeding this Court finds the indicia of forum shopping to be an important factor. “All courts should attempt to protect both the state and federal court systems from the illegitimate gamesmanship involved in forum shopping.” *In re Republic Reader’s Serv., Inc.*, 81 B.R. 422, 428 (Bankr. S.D. Tex.1987). ASA filed the original action in California state court in November 2003, seeking to recover money owed on the work it performed under the Subcontract. That suit was disposed of in favor of ASA on a motion for summary judgment, in part because of sanctions imposed against Gilbane in March 2005 for discovery abuse that precluded it from presenting certain pieces of evidence. Seven days after Gilbane filed its answer to the motion for summary judgment, which could not refer to the excluded evidence, Gilbane filed this adversary proceeding. The California state court entered a judgment for ASA on Sept. 13, 2005, and Gilbane has appealed in the California state court system.

Gilbane has argued in both the California state court action and in this adversary proceeding that it had no notice of the assignment of the Subcontract from Encompass/ASI to ASA. However, Gilbane did have notice of the assignment no later than the date of receipt of the original complaint ASA filed in California, even if Gilbane had no constructive notice before that time. Therefore, Gilbane could have brought this adversary proceeding two years ago, immediately after the effective date of the Confirmed Plan. Instead, Gilbane chose to litigate in a California state court, and now that it has lost at the trial level, Gilbane wants this Court to assert jurisdiction over the matter and in effect terminate the ongoing appeal in California. This, the Court will not do. This Bankruptcy Court is not an insurer against the outcome of bad choices.
Many of the issues asserted in this adversary proceeding have a relationship to bankruptcy law and a bankruptcy court’s power to interpret and implement the plan it confirmed, particularly the requirements for assigning executory contracts found in 11 U.S.C. §365. Regardless, this Court finds that the other factors pertinent in the “related to” jurisdictional inquiry—when the claim arose, certain relevant provisions in the Confirmed Plan, how far the reorganization has proceeded, what parties are involved, whether state law or bankruptcy law applies, and the indices of forum shopping—all lead to the conclusion that assertion of jurisdiction is not appropriate in this proceeding.

IV. Conclusions of Law Regarding Permissive Abstention

Alternatively, even if this Court does have jurisdiction over the adversary proceeding, ASA has asked this Court to permissively abstain from hearing this proceeding. Permissive abstention is authorized statutorily by 28 U.S.C. §1334(c)(1), as a reflection of the United States Supreme Court’s decision in Marathon that non-Article III bankruptcy courts should not determine contract claims based on state law. Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982); In re Republic Reader’s Serv. Inc., 81 B.R. at 425. Even after Congress statutorily placed the bankruptcy courts within the district courts through the 1984 Amendments, bankruptcy courts are not mandated to hear claims “related to” an underlying bankruptcy case when these claims fall under the statutory and case law considerations for permissive abstention. In re Republic Reader’s Serv., Inc., 81 B.R. at 425. “The abstention provisions of the Act demonstrate the intent of Congress that concerns of comity and judicial convenience should be met, not by rigid limitations on the jurisdiction of federal courts, but by the discretion exercised by abstention when appropriate in a particular case.” In re Wood, 825 F.2d 90, 93 (5th Cir. 1987). The broad grant of jurisdiction found in 28 U.S.C. §1334(a) is only over the actual bankruptcy case itself. In re Republic Reader’s Serv. Inc., 81 B.R. at 426. Jurisdiction over “civil proceedings arising under title 11, or arising in or related to a case under title 11” is concurrent with “courts other than the district court....” 28 U.S.C. §1334(b). This provision narrows the grant of exclusive jurisdiction exercised by the bankruptcy court.

28 U.S.C. §1334(c)(1) reads: “[N]othing in this section prevents a district court in the interest of justice, or in the interest of comity with State courts or respect for State law, from abstaining from hearing a particular proceeding arising under title 11 or arising in or related to a case under title 11.” Whereas mandatory abstention must be raised by motion of a party, permissive abstention may be raised sua sponte. In re Gober, 100 F.3d 1195, 1207 n. 10 (5th Cir. 1996). The decision to abstain is left up to the broad discretion of the bankruptcy court. In re Wood, 825 F.2d at 93. There is nothing that will prevent a determination that permissive abstention is appropriate even where “some, but not all, of the requirements for mandatory abstention are met.” In re Gober, 100 F.3d at 1206.

The bankruptcy court may permissively abstain from adjudicating an adversary proceeding regardless of whether it is core or non-core under 28 U.S.C. §157. Permissive abstention is more appropriate when the proceeding is non-core or merely “related to” the underlying bankruptcy. As determined above, in the discussion concerning “related to” jurisdiction, this adversary proceeding is non-core.
Once a determination of whether the proceeding is core or non-core has been made, the court should look to several factors to determine if abstention is appropriate. These factors were articulated quite clearly in *Broyles v. U.S. Gypsum Co.*, 266 B.R. 778, 785 (E.D. Tex. 2001). They include:

1. the effect or lack thereof on the efficient administration of the estate if the court recommends [remand or] abstention;
2. extent to which state law issues predominate over bankruptcy issues;
3. difficult or unsettled nature of applicable law;
4. presence of related proceeding commenced in state court or other nonbankruptcy proceeding;
5. jurisdictional basis, if any, other than §1334;
6. degree of relatedness or remoteness of proceeding to main bankruptcy case;
7. the substance rather than the form of an asserted core proceeding;
8. the feasibility of severing state law claims from core bankruptcy matters to allow judgments to be entered in state court with enforcement left to the bankruptcy court;
9. the burden of the bankruptcy court’s docket;
10. the likelihood that the commencement of the proceeding in bankruptcy court involves forum shopping by one of the parties;
11. the existence of a right to a jury trial;
12. the presence in the proceeding of nondebtor parties;
13. comity; and
14. the possibility of prejudice to other parties in the action.


Upon consideration of these factors, this Court holds that permissive abstention in this adversary proceeding is appropriate even if it has “related to” jurisdiction under §1334. Because there is no estate in existence, there can be no effect on the administration of the Debtor’s estate. Additionally, the length of time between the confirmation of the Confirmed Plan and the commencement of this proceeding points toward a finding of little effect on the remaining efforts (if any) to fully consummate the Plan. Although bankruptcy law provides the basis for filing this
adversary proceeding between Gilbane and ASA, the underlying claim is fundamentally a state law issue. This claim is not a novel issue of law—it is, as has been asserted, a contract interpretation issue not requiring the expertise of the bankruptcy court.

This proceeding is also not related to the main bankruptcy case except that it involves the assignment of a contract confirmed by this Court and incorporated into the terms of the Confirmed Plan. The original Subcontract was entered into by a subsidiary of the Debtor, not the Debtor itself. The Subcontract was assigned well over two years ago, before the Plan was confirmed, and has been fully performed. The underlying issues involve a breach of contract between two non-debtors. These facts militate against a finding that this Court should adjudicate this litigation rather than allow the California suit to proceed through the appeal process.

Finally, the most important factor that directs this Court toward abstention is the overwhelming presence of indications that Gilbane is trying to take the proverbial second bite at the apple. As discussed above, Gilbane could have filed this proceeding over two years ago, when Gilbane claims to have first had official notice of the underlying bankruptcy. However, Gilbane chose not to do so. Whether this was a strategic move by Gilbane, or an oversight, does not matter to this Court. If this Court were to grant jurisdiction and adjudicate the suit, it would undoubtedly become involved in Rooker-Feldman issues of comity with the California state court. See D.C. Court of Appeals v. Feldman, 460 U.S. 462, 103 S.Ct. 1303, 75 L.Ed.2d 206 (1983); Rooker v. Fid. Trust Co., 263 U.S. 413, 44 S.Ct. 149, 68 L.Ed. 362 (1923). This Court would ultimately have to review the decision by the California trial court to grant the motion for summary judgment in favor of ASA because many of the same issues were raised in that motion. In effect, this Court would be challenging the California state trial court’s primary jurisdiction to adjudicate the dispute and the California appellate court’s jurisdiction to entertain the appeal. This Court is not the proper forum to make that challenge. Abstaining from hearing this suit will not result in prejudice to either party (or third parties) because these issues have been raised and adjudicated in what this Court believes was a proper forum: the state court in California.

V. Conclusion

Gilbane’s attempt to take a second bite at the apple will go unfulfilled. This Court cannot find jurisdiction in a situation where all the claims at issue have been determined in a state court proceeding and the Debtor’s estate no longer exists. Although there are issues raised in this suit that implicate bankruptcy law, a state court will be able to sufficiently determine the effect of the assignment clause in the PSA and the Debtor’s Confirmed Plan. Moreover, even if this Court does have jurisdiction over this proceeding, the interests of comity and Gilbane’s blatant attempt at forum shopping dictate that permissive abstention is appropriate.

For the reasons set forth above, this Court grants ASA’s Motion for Dismissal for lack of jurisdiction. A separate order granting the Motion will be entered on the docket simultaneously with the entry of this Memorandum Opinion on the docket.
APPENDIX 20(b)
RESORTS INTERNATIONAL

372 F.3d 154 (3rd Cir. 2004)

OPINION OF THE COURT

SCIRICA, Chief Judge.

This appeal addresses the scope of “related to” jurisdiction of the bankruptcy court for post-confirmation claims brought on behalf of a litigation trust against an accounting firm. The trustee sued the accounting firm for professional negligence and breach of contract for work it performed for the trust. The Bankruptcy Court declined to hear the claim, finding it lacked subject matter jurisdiction. The District Court disagreed and reversed. We will reverse the order of the District Court and remand for proceedings consistent with this opinion.

I.

A. Overview of Affected Parties

The underlying matter in this appeal is an accounting malpractice action. J. Louis Binder, the Trustee for the Resorts International, Inc. Litigation Trust, brought a claim in excess of $500,000 against accounting firm Price Waterhouse & Co. for professional malpractice and breach of contract in connection with accounting services performed for the Litigation Trust. The Trustee’s principal allegation is that Price Waterhouse erroneously reported in its audit that accrued interest on Litigation Trust accounts belonged to the debtor rather than to the Litigation Trust. Underlying this claim was a suit between the Litigation Trust and the debtor, Resorts International, Inc., over entitlement to the accrued interest. According to the Trustee, Price Waterhouse’s erroneous reports were relied on by the bankruptcy court to the Litigation Trust’s detriment.

The debtor, Resorts International, Inc., is not a party to the malpractice action. The debtor assigned to the Litigation Trustee all its rights, title, and interest in the Litigation Trust’s primary asset, its claim against Donald Trump and affiliated entities. Because the Bankruptcy Court confirmed the Reorganization Plan, the debtor’s estate no longer exists.

Nonetheless, the Trustee alleges the debtor’s estate would still be affected by the malpractice suit because the Litigation Trust is effectively a continuation of the bankruptcy estate. Furthermore, contends the Trustee, any recovery obtained in this action would necessarily become Trust assets, available to cover any liability that might arise in the accrued interest lawsuit or available for possible distribution to the beneficiaries of the Litigation Trust, who were former creditors of the debtor’s estate.

Price Waterhouse responds that the Litigation Trust, a legally distinct entity, is not a continuation of the bankruptcy estate for jurisdictional purposes. Moreover, Price Waterhouse contends the debtor is only tangentially affected by this malpractice action after it assigned away
its interests in the litigation claims, and the Litigation Trust beneficiaries traded their creditor status to attain rights to the Trust’s assets.

B. Facts


FN1. Resorts International, Inc. changed its name on June 30, 1995, to Griffin Gaming & Entertainment, Inc. For sake of clarity, we will continue to refer to it as Resorts International, Inc.

On August 28, 1990, the Bankruptcy Court issued an Order confirming the Second Amended Joint Plan of Reorganization. On Sept. 17, 1990, the parties entered into a Final Plan and Litigation Trust Agreement. The Final Plan created a Litigation Trust for the benefit of certain creditors. Section 7.10(a) of the Plan provided: “Litigation Trustee shall retain and preserve the Litigation Claims for enforcement, as representative of and successor to the Reorganizing Entities in accordance with Bankruptcy Code §§1123(b)(3)(B) and 1145(a).” The beneficial interests in the Litigation Trust were divided into ten million Litigation Trust Units and allocated to certain creditors, the Unitholders, under a formula set forth in §7.10(b) of the Plan. Under §7.10(d), each Unitholder was entitled to a pro rata share of any distribution from the Litigation Trust.

FN2. The Unitholders were the holders of allowed Class 3B Claims, allowed Resorts International, Inc. Debenture Claims, and allowed Other Class 3C Claims as defined by the Plan. In re Resorts Int’l, Inc., 199 B.R. 113, 115 n. 2 (Bankr.D.N.J.1996).

The assets assigned to the Litigation Trust were claims originally held by the debtor, Resorts International, Inc., against Donald J. Trump and affiliated entities, arising from Trump’s 1988 leveraged buyout of the Taj Mahal Resort. Upon formation of the Litigation Trust, the litigation claims were assigned to the Trustee. The Plan authorized the Trustee to prosecute the claims against the Trump entities. The Plan and Litigation Trust Agreement also required the debtor to provide an irrevocable letter of credit in the amount of $5,000,000 to the Litigation Trust to enable it to pursue the litigation claims.

On May 28, 1991, the Trustee entered into an agreement with Trump and his affiliates and the debtor settling the litigation claims on behalf of the Trust’s Unitholders in the amount of $12,000,000, subject to approval by the Unitholders. Approval was solicited and received by July 15, 1991. The Settlement Agreement proceeds became assets of the Litigation Trust.

The Litigation Trust Agreement contained several provisions affecting Price Waterhouse, though it was never named in the document. Section 3.2 of the Litigation Trust Agreement provided that “[t]he Trustee shall retain an independent public accounting firm to audit the
financial books and records of the Trust and to perform such other reviews or audits as may be appropriate in the Trustee’s sole discretion,” and that the Trustee “shall pay such accounting firm reasonable compensation from the Trust Assets” for its services. Section 5.5 of the Litigation Trust Agreement required the Trustee to report to all Unitholders the details of the Trust’s transactions and disbursements at least annually and to have these reports “audited by the independent accounting firm retained by the Trustee ... not less frequently than annually.”

On April 17, 1990, representatives of the Litigation Trust’s Unitholders elected Kenneth R. Feinberg as Litigation Trustee. On Nov. 1, 1990, after confirmation of the Plan, the Trustee retained Price Waterhouse to provide auditing and tax-related services to the Litigation Trust. Subsequently, under an order dated August 17, 1994, J. Louis Binder replaced Feinberg as Trustee. Shortly thereafter, the Trustee terminated the services of Price Waterhouse. On April 15, 1997, the Trustee filed this adversary proceeding against Price Waterhouse alleging professional negligence and breach of contract.

The Trustee alleged Price Waterhouse committed professional malpractice by making several errors in its accounting and tax advice. His principal allegation is that Price Waterhouse erroneously reported in its audit reports that certain accrued interest on the Litigation Trust accounts belonged to the debtor rather than to the Trust. The accrued interest was the subject of a dispute between the debtor and the Litigation Trust—a dispute the Bankruptcy Court decided in part in favor of the debtor and in part in favor of the Trust. See In re Resorts Int’l, 199 B.R. at 118-19.FN3 The Trustee alleged that to the extent the Bankruptcy Court approved the debtor’s claim to the interest, it relied on Price Waterhouse’s audit reports, so that its “errors” injured the Litigation Trust. The Trustee alleged that even though the Trust partially prevailed in the interest dispute, Price Waterhouse’s erroneous characterization caused the Trust to incur unnecessary litigation costs in defending its entitlement. The Trustee also alleged certain errors in tax advice and auditing provided to the Trustee and faulted Price Waterhouse for failing to review and interpret certain Litigation Trust documents. The Trustee sought damages and disgorgement of fees in excess of $500,000.

FN3. The Bankruptcy Court allocated the interest between the Litigation Trust and the debtor in the following manner:

Interest income earned on the Expense Account for the period beginning on or about Oct. 3, 1990 through May 28, 1991 belongs to Resorts. Upon settlement of the Litigation Claims, the balance of the $5 million deposit became a “Trust Asset” as defined by Article II of the Litigation Trust Agreement, and any interest earned on such “Trust Asset” also became a “Trust Asset.” Accordingly, the Litigation Trust is entitled to interest earned on the balance of the initial $5 million deposit for the period beginning May 28, 1991 through the present date. To the extent that the Settlement Agreement dated May 28, 1991 between the former Litigation Trustee Feinberg and Resorts provided for interest income earned on the Expense Account for the period March 16, 1991 through May 28, 1991 to be paid to Resorts, the Litigation Trust’s entitlement to interest shall accrue from the post-settlement period following May 28, 1991.
C. Procedural History

On April 15, 1997, almost seven years after Reorganization Plan confirmation, the Trustee filed the underlying professional malpractice action against Price Waterhouse in the United States Bankruptcy Court for the District of New Jersey. On Jan. 4, 2002, the Bankruptcy Court granted Price Waterhouse’s motion to dismiss for lack of subject matter jurisdiction finding there was no “related to” or “core” jurisdiction. Binder v. Price Waterhouse & Co. (In re Resorts Int’l, Inc.), Adv. No. 97-2283, slip op. at 22, 30, 35 (Bankr. D. N.J. Jan. 4, 2002). Disagreeing with the Trustee that this was a “core” proceeding, the Bankruptcy Court characterized the matter as a post-confirmation dispute between two non-debtors involving state law claims that did not affect the “administration of the estate, property of the estate, or liquidation of assets of the estate.” Id. at 21. Although finding its post-confirmation jurisdiction to be “extremely limited,” the Bankruptcy Court recognized that it retained post-confirmation jurisdiction over disputes that potentially “affect the successful implementation and consummation of the plan.” Id. at 28 (internal quotations omitted). But the Bankruptcy Court rejected “related to” jurisdiction because the claims could not have had any “conceivable effect on the administration of the estate,” and because the dispute would not significantly affect consummation of the Reorganization Plan. See id. at 29-32. It also found that none of the Plan’s retention provisions were intended to serve as a basis for jurisdiction over the Litigation Trust and third-party accountants; nor could the Plan language create jurisdiction greater than that granted by Congress. Id. at 13-14.

The Trustee appealed to the District Court, which reversed and remanded. Binder v. Price Waterhouse & Co. (In re Resorts Int’l, Inc.), No. 02-1333, slip op. at 19 (D. N.J. Dec. 18, 2002). The District Court held “the terms on which the Litigation Trust was created and its practical role in the Plan lead to the conclusion that claims arising from professional misconduct in the Trust’s affairs are sufficiently related to the bankruptcy case to be within the jurisdiction of the Bankruptcy Court.” Id. at 7. The Court explained:

[C]onfirmation did not terminate the estate with respect to the property vested in the Litigation Trust; and the Trust represented a partial continuation of the estate. Consequently, the jurisdiction of the bankruptcy court over proceedings arising from the affairs of the Litigation Trust is not substantially different from its jurisdiction over similar matters pre-confirmation, and it should have the power to hear claims of professional malpractice in the administration of the Trust.

Id. at 12. But in light of the “uncertainties surrounding the exercise of Bankruptcy Court jurisdiction post-confirmation,” the District Court certified its ruling for immediate appeal under 28 U.S.C. §1292(b). Id. at 17-18. Price Waterhouse petitioned for leave to appeal. The Trustee chose not to contest the petition. We granted leave to appeal.

Price Waterhouse claims the District Court erred in upholding “related to” bankruptcy jurisdiction because there can be no conceivable effect on the administration of the estate. Furthermore, it contends, the District Court’s judgment, if permitted to stand, threatens unending jurisdiction in the Bankruptcy Court well after dissolution of the debtor’s estate. The Trustee
counters that this professional malpractice cause of action involves parties, assets, and issues central to the Reorganization Plan and is “related to” the bankruptcy, especially given the sweeping jurisdictional retention provisions in the Plan and Litigation Trust Agreement.

The jurisdiction of the Bankruptcy Court is at issue. The District Court had jurisdiction to review the Bankruptcy Court’s order under 28 U.S.C. §158. We have jurisdiction under 28 U.S.C. §1292(b). Our review of the District Court’s order on jurisdiction is de novo. Resolution Trust Corp. v. Swedeland Dev. Group (In re Swedeland Dev. Group), 16 F.3d 552, 559 (3d Cir.1994). FN4

FN4. We agree with the District Court that the challenge is a facial attack regarding an issue of law rather than a factual attack and accordingly will assume the truth of the allegations in the Complaint. See Binder, No. 02-1333, slip op. at 7-8.

II.

Both the Reorganization Plan and Litigation Trust Agreement contain retention of jurisdiction provisions. Article XI of the Plan provides in part:

The Bankruptcy Court will retain jurisdiction of the Reorganizing Cases for the following purposes: … (c) To ensure that the distribution of Holders of Claims and Interests are [sic] accomplished as provided herein; … (h) To hear and determine disputes arising in connection with the Plan or its implementation including disputes arising under agreements, documents or instrument executed in connection with this Plan; … (i) To construe and to take any action to enforce the Plan and issue such orders as may be necessary for the implementation, execution, and consummation of the Plan; … (o) To hear and determine any other matters not inconsistent with Chapter 11 of the Bankruptcy Code.

Article VIII of the Litigation Trust Agreement provides: The Bankruptcy Court shall retain exclusive jurisdiction over the Litigation Claims and Counterclaims, the Trust, the Trustee, and the Trust Assets, as provided for in the Plan, including, without limitation, the determination of all controversies and disputes arising under or in connection with this Trust Agreement.

The Trustee contends these provisions confer bankruptcy court jurisdiction over this dispute because the Litigation Trust Agreement falls within the definition of agreements, documents, or instruments executed in connection with the Plan. Furthermore, the Trustee contends the dispute involves the performance of professionals whose retention was mandated and whose duties were specified by the Litigation Trust Agreement. The Trustee stresses that, under the Agreement, the Bankruptcy Court’s retention over any dispute according to the Agreement was “not only comprehensive it was exclusive.” Appellee’s Br. at 9 (emphasis in original).

Retention of jurisdiction provisions will be given effect, assuming there is bankruptcy court jurisdiction. But neither the bankruptcy court nor the parties can write their own jurisdictional ticket. Subject matter jurisdiction “cannot be conferred by consent” of the parties. Coffin v. Malvern Fed. Sav. Bank, 90 F.3d 851, 854 (3d Cir. 1996). Where a court lacks subject
matter jurisdiction over a dispute, the parties cannot create it by agreement even in a plan of reorganization. *In re Continental Airlines, Inc.*, 236 B.R. 318, 323 (Bankr. D. Del.1999), *aff’d*, 2000 WL 1425751 (D. Del. Sept. 12, 2000), *aff’d*, 279 F.3d 226 (3rd Cir. 2002). Similarly, if a court lacks jurisdiction over a dispute, it cannot create that jurisdiction by simply stating it has jurisdiction in a confirmation or other order. *Id.; accord United States Trustee v. Gryphon at the Stone Mansion*, 216 B.R. 764, 769 (W.D. Pa. 1997) (“A retention of jurisdiction provision within a confirmed plan does not grant a bankruptcy court jurisdiction.”), *aff’d*, 166 F.3d 552 (3d Cir. 1999). Bankruptcy courts can only act in proceedings within their jurisdiction. *Donaldson v. Bernstein*, 104 F.3d 507, 552 (3d Cir.1999). If there is no jurisdiction under 28 U.S.C. §1334 or 28 U.S.C. §157, retention of jurisdiction provisions in a plan of reorganization or trust agreement are fundamentally irrelevant. But if there is jurisdiction, we will give effect to retention of jurisdiction provisions. Consequently, we will examine whether this dispute falls within the Bankruptcy Court’s subject matter jurisdiction.

### III.


28 U.S.C. §1334 grants jurisdiction over bankruptcy cases and proceedings to the district court: the district courts “shall have original and exclusive jurisdiction of all cases under title 11,” and “original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11.” *Id. at (a)-(b). Procedurally, a district court may refer all cases and proceedings that fall within this section to the bankruptcy court. 28 U.S.C. §157(a) provides: “Each district court may provide that any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11 shall be referred to the bankruptcy judges for the district.” *Id. The district courts’ power to refer is discretionary, but courts “routinely refer” most bankruptcy cases to the bankruptcy court. *Torkelsen v. Maggio (In re Guild & Gallery Plus, Inc.), 72 F.3d 1171, 1175 (3d Cir. 1996).*

Bankruptcy court jurisdiction potentially extends to four types of title 11 matters, pending referral from the district court: “‘(1) cases under title 11, (2) proceeding arising under title 11, (3) proceedings arising in a case under title 11, and (4) proceedings related to a case under title 11.’ “ *In re Guild & Gallery Plus, 72 F.3d at 1175* (quoting *In re Marcus Hook Dev. Park, Inc.*, 943 F.2d 261, 264 (3d Cir. 1991)). Cases under title 11, proceedings arising under title 11, and proceedings arising in a case under title 11 are referred to as “core” proceedings; whereas proceedings “related to” a case under title 11 are referred to as “non-core” proceedings. *See 1 Collier on Bankruptcy*, P3.02[2], at 3-35 (15th ed. rev. 2003). Congress vested the bankruptcy
courts with full adjudicative power with regard to “core” proceedings, subject to appellate review by the district courts. 28 U.S.C. §§157(b)(1), 158(a), (c). At the same time, it provided that, for “non-core” proceedings that are otherwise related to a case under title 11, the bankruptcy court “shall submit proposed findings of fact and conclusions of law to the district court” subject to de novo review by that court. 28 U.S.C. §157(c)(1).

A. Core Proceedings

28 U.S.C. §157(b)(1) provides that “[b]ankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments, subject to review under §158 of this title.” Id. 28 U.S.C. §157(b)(2) provides a non-exhaustive list of examples of core proceedings such as “matters concerning the administration of the estate,” “orders to turn over property of the estate,” or “other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims.” Id. FN5 We have held that a core proceeding under §157 is one that “‘invokes a substantive right provided by title 11’ “ or one that “‘by its nature, could arise only in the context of a bankruptcy case.’ “ In re Guild & Gallery Plus, 72 F.3d at 1178 (quoting In re Marcus Hook, 943 F.2d at 267).

FN5. The full list of examples of core proceedings follows:

(A) matters concerning the administration of the estate; (B) allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interests for the purposes of confirming a plan under chapter 11, 12, or 13 of title 11 but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11; (C) counterclaims by the estate against persons filing claims against the estate; (D) orders in respect to obtaining credit; (E) orders to turn over property of the estate; (F) proceedings to determine, avoid, or recover preferences; (G) motions to terminate, annul, or modify the automatic stay; (H) proceedings to determine, avoid, or recover fraudulent conveyances; (I) determinations as to the dischargeability of particular debts; (J) objections to discharges; (K) determinations of the validity, extent, or priority of liens; (L) confirmations of plans; (M) orders approving the use or lease of property, including the use of cash collateral; (N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate; and (O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims.

The Trustee argues this matter qualifies as a “core” proceeding, relying on *Southmark Corp. v. Coopers & Lybrand (In re Southmark Corp.),* 163 F.3d 925 (5th Cir. 1999). In *Southmark,* the court concluded that a debtor’s suit against an accounting firm was a core proceeding in bankruptcy, observing that the bankruptcy court must be able to ensure “that court-approved managers of the debtor’s estate are performing their work conscientiously, and cost-effectively.” *Id.* at 931. The court also noted that supervising court-appointed professionals “bears directly on the distribution of the debtor’s estate. If the estate is not marshaled and liquidated or reorganized expeditiously, there will be far less money available to pay creditors’ claims.” *Id.*

Notwithstanding the Trustee’s arguments, it is difficult to see how this malpractice matter could be considered a “core” proceeding. It is not a proceeding that invokes a substantive right provided by title 11 or a proceeding that, by its nature, could arise only in the context of a bankruptcy case. *In re Guild and Gallery Plus,* 72 F.3d at 1178.

Unlike in *Southmark,* this claim arose post-plan confirmation. It does not directly affect the debtor or the liquidation of the estate’s assets. Furthermore, the accounting firm’s alleged malpractice in *Southmark* implicated the integrity of the entire bankruptcy process. Southmark’s bankruptcy arose out of its involvement in Drexel Burnham Lambert, Inc.’s ill-fated junk bond investments. *Southmark,* 163 F.3d at 927-28. Southmark sought the appointment of an accounting firm to provide an objective, independent assessment of potential legal claims against third-parties. *Id.* Unbeknownst to Southmark, Drexel was one of the accounting firm’s largest clients. *Id.* at 927-28. According to Southmark, the accounting firm committed malpractice by failing to satisfactorily investigate potential claims against Drexel. *Id.* Southmark alleged the accounting firm’s breach of its court-appointed fiduciary duty prevented the estate from recovering from Drexel. *Id.* at 928. The accounting firm’s failure to investigate Drexel implicated the core of the bankruptcy process. Its alleged malpractice was inseparable from the bankruptcy context. Here, Price Waterhouse’s alleged malpractice, erroneously reporting that certain accrued interest belonged to one entity rather than to another and committing other errors in auditing and tax advice, even if true, is not a proceeding that could arise only in the bankruptcy context.

Regardless, we need not resolve whether this is a “core” proceeding for subject matter jurisdictional purposes because “[w]hether a particular proceeding is core represents a question wholly separate from that of subject-matter jurisdiction.” *In re Marcus Hook,* 943 F.2d at 266. Under 28 U.S.C. §157, a bankruptcy court might have jurisdiction over a proceeding but still might not be able to enter final judgments and orders. *Id.* Non-core “related to” jurisdiction is the broadest of the potential paths to bankruptcy jurisdiction, so we need only determine whether a matter is at least “related to” the bankruptcy. *Donaldson,* 104 F.3d at 552.

**B. Non-Core “Related To” Proceedings**

1. **The Pacor Test.**

With “related to” jurisdiction, Congress intended to grant bankruptcy courts “comprehensive jurisdiction” so that they could “deal efficiently and expeditiously” with matters connected with the bankruptcy estate. *Celorox Corp. v. Edwards,* 514 U.S. 300, 115 S.Ct.
Appendix 20(b) - Resorts International

1493, 131 L.Ed.2d 403 (1995) (quoting Pacor, Inc. v. Higgins, 743 F.2d 984, 994 (3d Cir.1984)). Nonetheless, a bankruptcy court’s “related to” jurisdiction “cannot be limitless.” Id. We set forth the seminal test for determining the boundaries of “related to” jurisdiction in Pacor, 743 F.2d at 994 FN6.

FN6. The Supreme Court effectively has overruled Pacor with respect to its holding that the prohibition against review of a remand order in 28 U.S.C. §1447(d) is not applicable in a bankruptcy case. See Things Remembered, Inc. v. Petrarca, 516 U.S. 124, 116 S.Ct. 461 (1995). But Things Remembered does not disturb the authority of Pacor on the points for which we cite it. In fact, the Pacor test “has been enormously influential” as a “cogent analytical framework” relied upon by our sister circuits more than any other case in this area of the law. In re Guild & Gallery Plus, 72 F.3d at 1181.

Under Pacor, bankruptcy courts have jurisdiction to hear a proceeding if “the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy.” Id. In In re Marcus Hook, 943 F.2d 261, we emphasized that a key word in this test is “conceivable” and that “[c]ertainty, or even likelihood, is not a requirement.” Id. at 264. In Pacor, we observed: “[T]he proceeding need not necessarily be against the debtor or against the debtor’s property. An action is related to bankruptcy if the outcome could alter the debtor’s rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts upon the handling and administration of the bankrupt estate.” 743 F.2d at 994. The Supreme Court has explained that the critical component of the Pacor test is that “bankruptcy courts have no jurisdiction over proceedings that have no effect on the estate of the debtor.” Celotex, 514 U.S. at 308 n. 6, 115 S.Ct. 1493.

(2) The Post-Confirmation Context of the “Related To” Inquiry.

As noted, Pacor and its progeny provide the analytical framework for determining “related to” jurisdiction. But most of the cases decided under Pacor do not arise post-confirmation or even after the creation of a litigation trust. Litigation trusts, which serve a valid purpose in the bankruptcy process, may continue long after a reorganization plan has been confirmed and the debtor has emerged from bankruptcy. And yet bankruptcy jurisdiction may still obtain if there is sufficient connection to the bankruptcy.

The post-confirmation context of this dispute affects our “related to” inquiry because bankruptcy court jurisdiction “must be confined within appropriate limits and does not extend indefinitely, particularly after the confirmation of a plan and the closing of a case.” Donaldson, 104 F.3d at 553. After confirmation of a reorganization plan, retention of bankruptcy jurisdiction may be problematic. See Bank of La. v. Craig’s Stores of Tex., Inc. (In re Craig’s Stores of Tex., Inc.), 266 F.3d 388, 391 (5th Cir. 2001); In re Fairfield Cmty., Inc., 142 F.3d 1093, 1095-96 (8th Cir. 1998). This is so because, under traditional Pacor analysis, bankruptcy jurisdiction will not extend to a dispute between non-debtors unless the dispute creates “the logical possibility that the estate will be affected.” In re Federal-Mogul Global, Inc., 300 F.3d 368, 380 (3d Cir. 2002) (internal quotations omitted), cert. denied, 537 U.S. 1148, 123 S.Ct. 884,
At the most literal level, it is impossible for the bankrupt debtor’s estate to be affected by a post-confirmation dispute because the debtor’s estate ceases to exist once confirmation has occurred. See *In re Fairfield Cmtys.*, 142 F.3d at 1095 (holding that once a bankrupt debtor’s plan has been confirmed the debtor’s estate ceases to exist). Unless otherwise provided by the plan or order confirming the plan, “the confirmation of a plan vests all of the property of the estate” in the reorganized debtor. 11 U.S.C. §1141(b). See also *NVF Co. v. New Castle County*, 276 B.R. 340, 348 (D.Del.2002) (holding that the confirmation of a plan revests the estate’s property in the reorganized debtor, and accordingly, the bankruptcy estate “no longer existed”), aff’d 61 Fed.Appx. 778 (3d Cir.2003).

FN7. The District Court recognized that “special considerations dictate that the application of the *Pacor* test provides jurisdiction over a narrower range of cases post-confirmation than pre-confirmation.” *Binder*, No. 02-1333, slip op. at 10. Other courts have also recognized how confirmation affects bankruptcy jurisdiction, though they have not specifically done so in cases involving litigation trusts. See *H & L Developers v. Arvida/JMB Partners (In re H & L Developers)*, 178 B.R. 71, 76 (Bankr. E.D. Pa. 1994) (“[O]nce a plan has been confirmed, the court’s jurisdiction begins to weaken.”) (internal quotations omitted); *Eastland Partners Ltd. v. Brown (In re Eastland Partners Ltd.)*, 199 B.R. 917, 919-20 (Bankr.E.D.Mich.1996) (“Following confirmation of a chapter 11 debtor’s plan, a bankruptcy court has a fairly narrow jurisdiction.”).

But courts do not usually apply *Pacor*’s “effect on the bankruptcy estate” test so literally as to entirely bar post-confirmation bankruptcy jurisdiction. As the District Court correctly noted, though the scope of bankruptcy court jurisdiction diminishes with plan confirmation, bankruptcy court jurisdiction does not disappear entirely. *Binder*, No. 02-1333, slip op. at 9. Post-confirmation jurisdiction is assumed by statute and rule: 11 U.S.C. §1142(b) authorizes the bankruptcy court to “direct the debtor and any other necessary party ... to perform any other act ... that is necessary for the consummation of the plan,” id., and Fed. R. Bankr. P. 3020(d) provides that “[n]otwithstanding the entry of the order of confirmation, the court may issue any other order necessary to administer the estate.” Id. Although §1142(b) assumes that post-confirmation jurisdiction exists for disputes concerning the consummation of a confirmed plan, 28 U.S.C. §1334 remains the source of this jurisdiction. *In re United States Brass Corp.*, 301 F.3d at 306.

Moreover, several courts have preserved post-confirmation jurisdiction in the bankruptcy court. See *Gryphon*, 166 F.3d at 555-56 (holding that the bankruptcy court had post-confirmation jurisdiction because a trustee’s action to enforce a fee provision was related to and arising in the bankruptcy); *Donaldson*, 104 F.3d at 552-54 (upholding post-confirmation bankruptcy court jurisdiction where the debtors failed to fund the reorganization plan and failed to pay unsecured creditors as required by the plan). And courts have upheld post-confirmation jurisdiction in situations involving trusts and similar entities. See *Bergstrom v. Dalkon Shield Claimants Trust (In re A.H. Robins Co.)*, 86 F.3d 364, 372-73 (4th Cir.1996) (upholding bankruptcy jurisdiction over a professional fees dispute between a claimants’ trust and attorneys representing claimants on the trust).
Other courts have also upheld post-confirmation bankruptcy jurisdiction over continuing trusts. See *New Nat’l Gypsum Co. v. Nat’l Gypsum Co. Settlement Trust (In re Nat’l Gypsum Co.)*, 219 F.3d 478, 479, 493 (5th Cir.2001) (assuming bankruptcy court jurisdiction over a post-confirmation proceeding involving a settlement trust where the court had to interpret the plan of reorganization in order to resolve a dispute); *Plotner v. AT & T Corp.*, 224 F.3d 1161, 1171 (10th Cir. 2000) (holding that a post-confirmation fraud action involving a plan-created trust was related to the bankruptcy proceeding); *United States v. Unger*, 949 F.2d 231, 233-35 (8th Cir.1991) (holding a bankruptcy court had post-confirmation jurisdiction when a representative of the creditors committee deposited trust funds into his personal account in contravention of the plan); *Mayor v. W. Va. (In re Eagle-Picher Indus., Inc.)*, 285 F.3d 522, 524 (6th Cir. 2002) (assuming without analysis post-confirmation bankruptcy jurisdiction over a dispute involving a settlement trust).

Courts have applied varying standards to determine whether “related to” jurisdiction should be upheld post-confirmation. We noted in *Donaldson*, 104 F.3d 547, that some courts have held that the act of plan confirmation changes the *Pacor* test from “whether the outcome of the proceeding could conceivably have any effect on the estate being administered” to “whether the outcome could ‘significantly affect[ ] consummation of the plan as confirmed.’” *Id.* at 553 (quoting *Grimes v. Graue (In re Haws)*, 158 B.R. 965, 970 (Bankr. S.D. Tex.1993)). In *Donaldson*, we declined to determine the “precise standard” to apply post-confirmation. *First W. SBLC, Inc. v. Mac-Tav, Inc.*, 231 B.R. 878, 882 (D. N.J. 1999). Subsequently, in *Gryphon*, 166 F.3d 552, we applied the *Pacor* test to resolve a claim for post-confirmation fees brought by a United States Trustee, querying whether the dispute “could conceivably have any effect on the estate being administered in bankruptcy” and holding that the matter satisfies the *Pacor* test “because it directly relates to the debtor’s liabilities—in fact it creates a liability—and could impact the handling and administration of the estate.” *Id.* at 556. And in *Gryphon*, we held that though 11 U.S.C. §1142 FN10 provides that the bankruptcy court may take action to ensure the consummation of a confirmed plan, the bankruptcy court may entertain other post-confirmation actions as well. 166 F.3d at 556.

Other courts have applied similar tests that assess whether the dispute could conceivably affect the implementation or consummation of the confirmed plan. See *Trans World Airlines, Inc. v. Karabu Corp.*, 196 B.R. 711, 714 (Bankr. D. Del. 1996) (“[T]his court has subject matter jurisdiction over any proceeding that conceivably could affect [the debtor’s] ability to consummate the confirmed plan.”); *In re Walker*, 198 B.R. 476, 482 (Bankr. E.D. Va. 1996) (“Jurisdiction over certain post-confirmation disputes remains with the Bankruptcy Court to the extent that those disputes might affect the successful implementation and consummation of the confirmed plan.”); *Eubanks v. Esenjay Petroleum Corp.*, 152 B.R. 459, 464 (E.D. La. 1993) (Bankruptcy courts maintain jurisdiction if the proceeding has “a conceivable effect on the debtor’s ability to consummate the confirmed plan.”). Some courts have been...
reluctant to apply such a broad standard post-confirmation but have nonetheless found that bankruptcy court jurisdiction continues post-confirmation. See In re Craig’s Stores of Tex., 266 F.3d at 391 (holding that a bankruptcy court has jurisdiction over a civil proceeding if the litigated matter “bear[s] on the interpretation or execution of the debtor’s plan”); In re Dilbert’s Quality Supermarkets, Inc., 368 F.2d 922, 924 (2d Cir.1966) (holding that bankruptcy court jurisdiction continues post-confirmation at least “to protect its decree, to prevent interference with the execution of the plan and to aid otherwise in its operation”); In re Leeds Bldg. Prod., Inc., 160 B.R. 689, 691 (Bankr. N.D. Ga.1993) (concluding that the bankruptcy court’s role post-confirmation “is limited to matters involving the execution, implementation, or interpretation of the plan’s provisions, and to disputes requiring the application of bankruptcy law”).

FN10. 11 U.S.C. §1142(b) authorizes the bankruptcy court to “direct the debtor and any other necessary party ... to perform any other act ... that is necessary for the consummation of the plan.” Id.

Though courts have varied the standard they apply post-confirmation, the essential inquiry appears to be whether there is a close nexus to the bankruptcy plan or proceeding sufficient to uphold bankruptcy court jurisdiction over the matter. For example, in Donaldson, 104 F.3d 547, we upheld bankruptcy court jurisdiction because the trustee through the lawsuit was “basically ... seeking to carry out the intent of the reorganization plan.” Id. at 553. We distinguished the matter from other cases denying jurisdiction because it had a “much closer nexus to the bankruptcy case.” Id. In upholding jurisdiction, we found significant the fact that the case did “not involve a dispute essentially collateral to the bankruptcy case.” Id. Rather, the action “implicat[ed] the integrity of the bankruptcy process” because one party’s actions impaired the other party’s ability to act in accordance with the plan. Id. The post-confirmation fee dispute in Gryphon, 166 F.3d 552, also had a close nexus to the bankruptcy proceeding because it involved a U.S. Trustee’s action to enforce a post-confirmation fee provision and created a liability for the debtor. Id. at 555. At the post-confirmation stage, the claim must affect an integral aspect of the bankruptcy process: There must be a close nexus to the bankruptcy plan or proceeding.

Whether a matter has a close nexus to a bankruptcy plan or proceeding is particularly relevant to situations involving continuing trusts, like litigation trusts, where the plan has been confirmed, but former creditors are relegated to the trust res for payment on account of their claims. To a certain extent, litigation trusts by their nature maintain a connection to the bankruptcy even after the plan has been confirmed. The question is how close a connection warrants post-confirmation bankruptcy jurisdiction. Matters that affect the interpretation, implementation, consummation, execution, or administration of the confirmed plan will typically have the requisite close nexus. Under those circumstances, bankruptcy court jurisdiction would not raise the specter of “unending jurisdiction” over continuing trusts.

An example of a dispute in which there was a sufficiently close nexus to the plan or proceeding to uphold bankruptcy court jurisdiction post-confirmation was an earlier proceeding
involving the Resorts International, Inc. bankruptcy. See *In re Resorts Int’l*, 199 B.R. 113 (Bankr. D. N.J. 1996). There, unlike here, the Bankruptcy Court was required to construe and enforce provisions of the Plan to resolve a post-confirmation dispute over whether the Litigation Trust or the debtor was entitled to accrued interest. *Id.* at 120-25. The court correctly held that it retained jurisdiction to enter appropriate orders to enforce the intent and specific provisions of the Plan. *Id.* at 118-19.

*Bergstrom*, 86 F.3d 364, and *Falise v. Am. Tobacco Co.*, 241 B.R. 48 (E.D.N.Y.1999), are useful for illustrating when there is a sufficiently close nexus to the bankruptcy plan or proceeding to uphold bankruptcy jurisdiction in post-confirmation situations involving continuing trusts. In *Bergstrom*, 86 F.3d 364, the dispute implicated an integral aspect of the bankruptcy process. The plan-created trust intended to distribute surplus funds to tort claimants on a *pro rata* basis. *Id.* at 367. But certain attorneys claimed entitlement to contingent fees. *Id.* The district court, sitting in bankruptcy, limited attorneys’ fees to 10 percent of the amounts distributed. *Id.* To resolve the dispute, it was necessary to interpret the plan’s accompanying documents to determine whether it was unreasonable to charge standard attorneys’ fees out of the *pro rata* distribution. See *id.* at 368-71. In upholding “related to” jurisdiction, the court explained why the dispute was central to the bankruptcy proceeding: “The Trust was created to protect and pay those persons who had been damaged by use of the Dalkon Shield. The efforts of the Trust to settle the remaining claims could easily be affected if the remaining claimants are aware that any attorneys’ fees out of the *pro rata* distribution will be limited to 10 percent.” *Id.* at 372. Accordingly, the dispute integrally affected the bankruptcy plan and proceeding, and it was appropriate for the district court, sitting in bankruptcy, to exercise jurisdiction over that proceeding.

In contrast, this kind of close nexus to the bankruptcy plan or proceeding was absent in *Falise*, 241 B.R. 48. *Falise* involved a dispute between tobacco manufacturers and a trust created as a result of the bankruptcy of an asbestos products producer. *Id.* at 51. The trust sought to recover from the tobacco companies for their role in contributing to asbestos-related illnesses. *Id.* Noting that the resolution of the dispute would require more than merely interpreting the plan’s terms, the court held that bankruptcy court jurisdiction does not extend to a “major suit” brought by the trust against non-parties to the bankruptcy or to any closely related proceeding. *Id.* at 52, 55. In *Falise*, the resolution of the dispute would have had no impact on any integral aspect of the bankruptcy plan or proceeding. Accordingly, it was appropriate to find no bankruptcy jurisdiction over that collateral matter.

*In re Haws*, 158 B.R. 965, similarly illustrates when a proceeding lacks a sufficiently close nexus to the bankruptcy plan or proceeding to uphold post-confirmation jurisdiction. There, the action was brought by a trustee for a liquidating trust against a partner of the debtor for breach of fiduciary duty. *Id.* at 967-68. In holding the matter to be outside bankruptcy court jurisdiction, the court noted the plaintiff had failed to demonstrate how any damages recovered from the defendant were “necessary to effectuate the terms of the” plan. *Id.* at 971. The court recognized that “[n]owhere in the lawsuit is the bankruptcy court being asked to construe or interpret the confirmed plan or to see that federal bankruptcy laws are complied with in the face of violations.” *Id.* It concluded: “The only nexus to this bankruptcy case is that the plaintiff in
this matter is a liquidating trustee representing a group of creditors appointed pursuant to the confirmed plan of reorganization.” *Id.*

*Montana v. Goldin (In re Pegasus Gold Corp.),* 296 B.R. 227 (D. Nev. 2003), is also instructive. A reclamation services corporation (“RSC”) was created under a reorganization plan for the purpose of performing short-term reclamation work “in order to benefit the overall Plan goal of preserving the jobs of Debtors’ employees to thereby maximize the possibility of creditor recovery.” *Id.* at 231. The Trustee and RSC contended the state of Montana had represented that RSC would be given preference in the bidding for long-term reclamation work. *Id.* at 232. They brought suit, alleging Montana breached the agreement by hiring a competitor to perform the reclamation work. *Id.* The court upheld bankruptcy court jurisdiction because RSC’s failure, and its inability to retain the debtors’ employees on account of Montana’s breach, “undermine[d] the Plan’s objectives for reorganization and the payment of creditors.” *Id.* at 233-35. The court held that the “facts demonstrate the necessary close nexus between appellees’ tort and contract claims and the bankruptcy proceeding.” *Id.* at 235.

As stated, the jurisdiction of the non-Article III bankruptcy courts is limited after confirmation of a plan. But where there is a close nexus to the bankruptcy plan or proceeding, as when a matter affects the interpretation, implementation, consummation, execution or administration of a confirmed plan or incorporated litigation trust agreement, retention of post-confirmation bankruptcy court jurisdiction is normally appropriate.

IV.

We now assess whether the Bankruptcy Court can exercise “related to” jurisdiction over these malpractice claims. As noted, the Trustee’s principal allegation was that Price Waterhouse erroneously reported in its audit reports that accrued interest on Litigation Trust accounts belonged to the debtor rather than to the Litigation Trust. The Trustee also alleged other errors in auditing and tax advice. Price Waterhouse’s errors, according to the Trustee, constituted professional negligence and breach of contract.

The Trustee has made several arguments why the malpractice claims are sufficiently connected to the bankruptcy process to uphold bankruptcy court jurisdiction: the claims affect the Litigation Trust, which is a continuation of the estate; the claims affect the debtor; the claims affect the operation of the Reorganization Plan; the claims affect the former creditors as beneficiaries of the Litigation Trust; and the jurisdictional retention provisions confer continued jurisdiction. The jurisdictional import of these arguments is not easily resolved.

Nonetheless, we believe this proceeding lacks a close nexus to the bankruptcy plan or proceeding and affects only matters collateral to the bankruptcy process. The resolution of these malpractice claims will not affect the estate; it will have only incidental effect on the reorganized debtor; it will not interfere with the implementation of the Reorganization Plan; though it will affect the former creditors as Litigation Trust beneficiaries, they no longer have a close nexus to bankruptcy plan or proceeding because they exchanged their creditor status to attain rights to the litigation claims; and as stated, the jurisdictional retention plans cannot confer jurisdiction greater than that granted under 28 U.S.C. §1334 or 28 U.S.C. §157. For these reasons, the
malpractice claims here lack the requisite close nexus to be within the Bankruptcy Court’s “related to” jurisdiction post-confirmation.

The Trustee argues the estate is affected because the Litigation Trust is a continuation of the estate. The District Court agreed, reasoning that the affairs of post-confirmation trusts are “effectively those of the estate (or at least analogous to those of the estate) for jurisdictional purposes.” *Binder*, No. 02-1333, slip op. at 12-13. Though the Litigation Trust’s assets, the proceeds from the litigation claims, were once assets of the estate, that alone does not create a close nexus to the bankruptcy plan or proceeding sufficient to confer bankruptcy jurisdiction. The Litigation Trust’s connection to the bankruptcy is not identical to that of the estate. Under §1.1 of the Litigation Trust, the debtor “absolutely assigned to the Trustee and to its successors and assigns, all right, title and interest of the Reorganizing Entities in and to the Litigation Claims.” Moreover, the Litigation Trust was created in part so that the Plan could be confirmed and the debtor freed from bankruptcy court oversight without waiting for the resolution of the litigation claims. The deliberate act to separate the litigation claims from the bankruptcy estate weakens the Trustee’s claim that the Litigation Trust has the same jurisdictional nexus as that of the estate. Given the limited jurisdiction of non-Article III bankruptcy courts, jurisdiction does not extend necessarily to all matters involving litigation trusts.

The Trustee also contends the resolution of the malpractice claim will affect the debtor, Resorts International, Inc. The debtor is not a party to this litigation because, as stated, under §1.1 of the Litigation Trust Agreement, it assigned away its right, title, and interest in the litigation claims. But the Trustee argues Resorts would still be affected by this dispute because it “is claiming to be a continuing creditor of the estate” due to the litigation over the accrued interest. Oral Argument Transcript at 32. Should Resorts prevail in that ongoing dispute, the Trustee contends Resorts may have a claim against the Litigation Trust, and an award in the malpractice action could be distributed back to Resorts to pay on that claim. Such attenuated effect on the reorganized debtor does not create a close nexus to the bankruptcy plan or proceeding sufficient to confer bankruptcy court jurisdiction. After assigning away its right, title, and interest in the Litigation Trust’s litigation claims, the reorganized debtor would have no greater claim to the proceeds from this malpractice action than any other Litigation Trust creditor. Any funds eventually received by the debtor as a result of the malpractice dispute would be incidental to the bankruptcy process.

FN11. Even though the Bankruptcy Court resolved the interest dispute in *In re Resorts Int’l*, 199 B.R. 113, according to the Trustee’s Complaint, the dispute is “ongoing” because Resorts International, Inc. and the Litigation Trust “remain engaged in negotiations over the form of the order and settlement of other issues.” Joint Appendix at 76.

The Trustee maintains that continuing jurisdiction over the matter is “essential to the integrity of the Plan and its implementation.” Appellee’s Br. at 2. We disagree. It is true that accounting services are essential in administering trusts, and in certain circumstances, accounting errors could have a sufficiently close nexus to the bankruptcy plan or proceeding to warrant exercising “related to” jurisdiction post-confirmation. But the resolution of the claims here will have no substantial effect on the success of the Plan.
Resolution of this matter will not require a court to interpret or construe the Plan or the incorporated Litigation Trust Agreement. Whether Price Waterhouse was negligent or breached its contract will not be determined by reference to those documents. There is no dispute over their intent. The Trustee’s claims are “ordinary” professional negligence and breach of contract claims that arise under state common law. Though the Plan and Trust Agreement provide the context of the case, this bare factual nexus is insufficient to confer bankruptcy jurisdiction.

The malpractice action could result in an increase in the Litigation Trust’s finite assets. But the potential to increase assets of the Litigation Trust and its beneficiaries does not necessarily create a close nexus sufficient to confer “related to” bankruptcy court jurisdiction post-confirmation. The Trust beneficiaries here no longer have the same connection to the bankruptcy proceeding as when they were creditors of the estate. For reasons they believed financially prudent, they traded their creditor status as claimants to gain rights to the Litigation Trust’s assets. Thus, their connection to the bankruptcy plan or proceeding is more attenuated. Furthermore, if the mere possibility of a gain or loss of trust assets sufficed to confer bankruptcy court jurisdiction, any lawsuit involving a continuing trust would fall under the “related to” grant. Such a result would widen the scope of bankruptcy court jurisdiction beyond what Congress intended for non-Article III bankruptcy courts. Accordingly, resolution of these malpractice claims will not affect the interpretation, implementation, consummation, execution, or administration of the Plan.\footnote{12}

\footnote{12. Price Waterhouse argues the matter turns in part on the fact that it was not explicitly named in the Litigation Trust Agreement or the Reorganization Plan and that the Bankruptcy Court did not approve its retention or dismissal. In some circumstances, these factors may affect the jurisdictional inquiry. But they are not significant here.}

Price Waterhouse also argues the lapse of time since confirmation factors against bankruptcy jurisdiction. The Bankruptcy Court issued an Order confirming the Plan on August 28, 1990. The Trustee filed this malpractice action on April 15, 1997. The Trustee responds that Price Waterhouse’s malpractice “began barely after the ink dried on the confirmation order,” and notes that Price Waterhouse released its allegedly erroneous report that the interest income belonged to the Debtor in 1992. Appellee’s Br. at 12-13. Though in some circumstances, the lapse of time since confirmation may be relevant to whether a matter has a “close nexus” to a bankruptcy plan or proceeding, we do not find it to be so here.

V.

For these reasons, there is no “related to” jurisdiction over the malpractice dispute, and it cannot find a home in the Bankruptcy Court. We will reverse the order of the District Court and remand for proceedings consistent with this opinion.
APPENDIX 20(d)
EXAMPLE OF PLAN AND JURISDICTION

Case No. 02-B-48191
IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

In re: ) Chapter 11

UAL Corporation, et al., ) Case No. 02-B-48191
Debtors. ) Honorable Eugene R. Wedoff
 ) (Jointly Administered)

DEBTORS' SECOND AMENDED JOINT PLAN OF REORGANIZATION
PURSUANT TO CHAPTER 11 OF THE UNITED STATES BANKRUPTCY CODE

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Counsel for the Debtors and Debtors in Possession
Dated: January 19, 2006

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ARTICLE XIV.
RETENTION OF JURISDICTION

Notwithstanding the entry of the Confirmation Order and the occurrence of the Effective Date, and subject to the rights of the United States of America or any Governmental Unit thereof and the State of California to argue that the Bankruptcy Court lacks or has limited or non-exclusive jurisdiction under applicable law, the Bankruptcy Court shall retain such exclusive jurisdiction over all matters arising out of, and related to, the Chapter 11 Cases and the Plan as legally permissible pursuant to Sections 105(a) and 1142 of the Bankruptcy Code, including, without limitation, jurisdiction to:

1. Allow, disallow, determine, liquidate, classify, estimate or establish the priority, Secured or Unsecured status, or amount of any Claim or Interest, including the resolution of any request for payment of any Administrative Claim and the resolution of any and all objections to the Secured or Unsecured status, priority, amount, or allowance of Claims or Interests;
2. Decide and resolve all matters related to the granting and denying, in whole or in part, any applications for allowance of compensation or reimbursement of expenses to Professionals authorized pursuant to the Bankruptcy Code or the Plan, for periods ending on or before the Confirmation Date;

3. Resolve any matters related to (a) the assumption, assumption and assignment, or rejection of any executory contract or unexpired lease to which a Debtor is party or with respect to which a Debtor may be liable and to hear, determine and, if necessary, liquidate, any Cure or Claims arising therefrom, including, without limitation, Cure or Claims pursuant to Section 365 of the Bankruptcy Code, (b) any potential contractual obligation under any executory contract or unexpired lease that is assumed, and (c) the Debtors or Reorganized Debtors amending, modifying, or supplementing, after the Effective Date, pursuant to ARTICLE VII of the Plan, any executory contracts or unexpired leases to the list of executory contracts and unexpired leases to be assumed or rejected otherwise; and (d) any dispute regarding whether a contract or lease is or was executory or expired; provided, however, that ordinary course prepetition grievances shall continue to be processed pursuant to the terms of the applicable Collective Bargaining Agreement;

4. Ensure that distributions to Holders of Allowed Claims and Allowed Interests are accomplished pursuant to the provisions of the Plan;

5. Adjudicate, decide, or resolve any motions, adversary proceedings, contested or litigated matters and any other matters and grant or deny any applications involving a Debtor that may be pending on the Effective Date;

6. Adjudicate, decide, or resolve any and all matters related to Causes of Action;

7. Adjudicate, decide, or resolve any and all matters related to Section 1141 of the Bankruptcy Code;

8. Enter and implement such orders as may be necessary or appropriate to execute, implement, or consummate the provisions of the Plan and all contracts, instruments, releases, indentures, and other agreements or documents created in connection with the Plan or the Disclosure Statement;

9. Resolve any cases, controversies, suits, disputes, or Causes of Action that may arise in connection with the Consummation, interpretation, or enforcement of the Plan or any Person's obligations incurred in connection with the Plan;

10. Issue injunctions, enter and implement other orders, or take such other actions as may be necessary or appropriate to restrain interference by any Entity with Consummation or enforcement of the Plan, except as otherwise provided in the Plan;

11. Resolve any cases, controversies, suits, disputes, or Causes of Action with respect to the releases, injunction, and other provisions contained in ARTICLE IX of the Plan and enter such orders as may be necessary or appropriate to implement such releases, injunction, and other provisions;
12. Resolve any cases, controversies, suits, disputes, or Causes of Action with respect to (a) the repayment and/or return of the distributions and (b) the recovery of additional amounts owed by the Creditor for amounts not timely repaid pursuant to ARTICLE IX.J.1 of the Plan;

13. Enter and implement such orders as are necessary or appropriate if the Confirmation Order is for any reason modified, stayed, reversed, revoked, or vacated;

14. Determine any other matters that may arise in connection with or relate to the Plan, the Disclosure Statement, the Confirmation Order, or any contract, instrument, release, indenture, or other agreement or document created in connection with the Plan or the Disclosure Statement;

15. Enter an order and/or Final Decree concluding or closing the Chapter 11 Cases;

16. Adjudicate any and all disputes arising from or relating to the distribution or retention of the New UAL Plan Securities, Cash, or other consideration pursuant to the Plan;

17. Hear and determine any and all objections to the allowance of Claims and Interests and the estimation of Claims, both before and after the Confirmation Date, including any objections to the classification of any Claim or Interest, and to allow or disallow any Claim or Interest, in whole or in part;

18. Consider any modifications of the Plan, to cure any defect or omission, or to reconcile any inconsistency in any Final Order of the Bankruptcy Court, including, without limitation, the Confirmation Order;

19. Determine requests for the payment of Claims entitled to priority pursuant to Section 507 of the Bankruptcy Code, including compensation and reimbursement of expenses of Entities entitled thereto;

20. Hear and determine disputes arising in connection with the interpretation, implementation, or enforcement of any Postpetition Aircraft Agreement.

21. Hear and determine matters arising out of, related to, or concerning the Section 1113 Restructuring Agreements and any related documents, the distributions and consideration called for in the Section 1113 Restructuring Agreements and any related documents, or the Debtors’ restructuring of their labor and pension costs.

22. Hear and determine disputes arising in connection with the interpretation, implementation, or enforcement of the Plan, the Confirmation Order, including disputes arising under agreements, documents, or instruments executed in connection with the Plan;

23. Hear and determine matters concerning state, local, and federal taxes in accordance with Sections 346, 505, and 1146 of the Bankruptcy Code;

24. Hear any other matter not inconsistent with the Bankruptcy Code;
25. Hear and determine all disputes involving the existence, nature, or scope of the Debtors' discharge, including any dispute relating to any liability arising out of the termination of employment or the termination of any employee or retiree benefit program, regardless of whether such termination occurred prior to or after the Effective Date;

26. Enforce all orders previously entered by the Bankruptcy Court;

27. Consider any request for relief pursuant to Title IV of the Employee Retirement Income Security Act or Section 1113 of the Bankruptcy Code as set forth in ARTICLE VII.F.2 of the Plan; and

28. Hear and determine matters concerning the Debtors’ sale of any insurance policies, the issuance of any injunctions prohibiting any persons from prosecuting any claims under any such insurance policies, and the provision of adequate protection to parties who prove valid interests in any such policies.
CHAPTER 21
BANKRUPTCY APPEALS

Just like the orders of other trial courts, bankruptcy court orders can be appealed. But there are important differences between bankruptcy appeals and appeals in other courts. First, only certain orders can be appealed. Second, they are appealed to different courts. Third, the procedural rules differ. Because bankruptcy cases move quickly, and appellate litigation tends to move less quickly, issues surrounding the effect of an appeal on the chapter 11 process need to be considered. We discuss these issues below.

What Orders Can Be Appealed?

Any final order of a bankruptcy court can be appealed. This includes orders entered in a contested matter (such as an order granting relief from the automatic stay or an order authorizing use of cash collateral) as well as orders entered in an adversary proceeding (such as an order granting summary judgment).

The difficult question is what is a final order of a bankruptcy court? One case defined a final order as one that “resolves the litigation, decides the merits, settles liability, establishes damages, or even determines the rights of any party to the bankruptcy case.” In re Urban Broadcasting Corp., 304 B.R. 263, 269 n.13 (E.D. Va. 2004) (internal citations omitted). The court contrasted this with an interlocutory order—“one which does not finally determine a cause of action but only decides some intervening matter pertaining to the cause, and which requires further steps to be taken to enable the court to adjudicate the cause on the merits.”

If an order meets the definition of a final order, it may be appealed. If it is interlocutory, then it may be appealed only with permission from the appellate court (more about that below). Sometimes it is not clear whether an order is final or interlocutory, and more than occasionally that issue is the subject of dispute.

It is sometimes said that bankruptcy courts have a more relaxed standard for what is a final order than nonbankruptcy courts. This is in part because, in the typical chapter 11 process, one event builds upon another. It is therefore often more economical and efficient to resolve issues on appeal when they arise (or as soon thereafter as possible), rather than having the chapter 11 process continue to move forward—under the assumption that some particular dispute has been resolved—only to have the result of the resolution reversed much later, and a lot of events or agreements based upon that resolution potentially unwound. In addition, appeals can be mooted by subsequent decisions that may be implemented (such as confirmation of a plan), and interpreting the finality requirement somewhat liberally may be the only way to grant an effective appellate right.

To What Court Can You Appeal?

It used to be that bankruptcy appeals automatically went to the district court. Title 28 was later amended to authorize the creation of bankruptcy appellate panels (“BAPs”)—specialized
three-judge courts (comprising of bankruptcy court judges from the particular circuit) designated to hear bankruptcy appeals. Currently, there are bankruptcy appellate panels in the First, Sixth, Eighth, Ninth, and Tenth circuits. The remaining circuits do not have BAPs. The details regarding formation of BAPs and appointment of BAP judges can be found in 28 U.S.C. §158(b). Where there is a BAP, appeals from bankruptcy court decisions go to the BAP unless one of the parties elects to have the appeal heard by a district court judge. See Bankruptcy Rule 8001(e) and 28 U.S.C. §158(c). The standard of appellate review is de novo on issues of law, clearly erroneous on issues of fact, and abuse of discretion on issues that are committed to the bankruptcy judge’s discretion.

Appeals from a decision of the BAP or district court can be taken to a United States Court of Appeals. See 28 U.S.C. §158(d). The standard of review is de novo. From there, it is possible to petition the Supreme Court for review.

Under BAPCPA, an appeal of a bankruptcy court’s order can be able to be taken directly to the court of appeals under some circumstances. If the bankruptcy court, the district court, the BAP, or all of the parties to the appeal certify that (i) the appeal involves a matter of public importance or a question of law that neither the circuit court nor the Supreme Court has addressed, (ii) the appeal requires resolution of conflicting decisions, or (iii) the appeal may materially advance the progress of the case, the appeal will go to the court of appeals unless it chooses not to accept it. In addition, the Code requires the relevant lower courts to make the certification to the court of appeals, if the majority of the appellants and appellees request certification. (We assume this is only required if the grounds are satisfied, although the statute doesn’t say that. In any event, it is up to the Court of Appeals whether to accept direct appeal of any bankruptcy court decision.)

What Is the Process for Appeals?

The procedural rules for appeals are in Part VIII of Bankruptcy Rule—the “8000 series” rules. Here’s a quick summary of the highlights:

- If you want to appeal a bankruptcy court decision, you must file a notice of appeal within 10 days after the order you are appealing from is entered. (Note that this is different than the 30 day period to appeal a district court’s order to a court of appeals—more than a few lawyers have just assumed they had 30 days, and found themselves having a conversation with their insurance carrier). The bankruptcy judge may grant a limited extension of the 10 day period for most, but not all, types of appeals. For the exceptions, see Bankruptcy Rule 8002(c). Usually, however, you will want to file within the 10 days rather than seeking an extension. If you want to pursue the direct route to the court of appeals under the new legislation, you must request certification within 60 days of the entry of the order.

- If you want to appeal an interlocutory order, you should file a notice of appeal and a motion for leave to appeal. If you just file a notice of appeal, and the order from which you are appealing is determined to be interlocutory, the court may direct you to file a motion or, alternatively, may treat your notice of appeal as a motion
for leave to appeal. See Bankruptcy Rule 8003(c). However, if you think your order is probably interlocutory, it is better to file the motion so you can explain why you should be permitted to appeal. When making this explanation, think in terms of the need to get your appeal resolved in order to give you an effective remedy and to avoid delaying the reorganization process to the detriment of all parties. Of course, the specifics will vary from case to case.

- If you are in one of the circuits that has a BAP but you want your appeal heard by a district judge rather than a BAP, you must file an election. See Bankruptcy Rule 8001(e) and 28 U.S.C. §158(c)(1) for the procedure and timing.

- If you need a stay pending appeal, the governing Bankruptcy Rule is 8005. The standard is generally something like the traditional injunction standard—likelihood of success on the merits, irreparable harm, the public interest, and balancing the equities. Ordinarily, you seek the stay first from the bankruptcy judge and if she denies the stay, then you can go to the district judge or BAP, and if need be to the court of appeals. Often the party seeking the stay will be required to post a bond as a condition of the stay.

  If you fail to obtain a stay, then the order from which you are appealing may be implemented during the pendency of your appeal. This can result in your appeal being mooted. A somewhat common example of this is an appeal from a plan confirmation order or a §363 Sale order. If you don’t get a stay and the plan is consummated or the sale closes, you may find your appeal being dismissed as “equitably moot.”

The notion is that the plan has been consummated, and parties have relied on the consummation, to an extent such that effective relief can no longer be granted to the appellant without unfairly upsetting the expectations of other parties. You hear a lot in this context about “un-ringing bells” and “un-scrambling eggs.” A similar result may be obtained in the case of an appeal from a post-petition financing order under §364 or an asset sale order under §363, as a result of statutory provisions. See §§364(e) and 363(m). These mootness doctrines provide an incentive for parties to consummate plans and close sale or financing transactions as soon after entry of the order approving them as possible, whether appeal has been taken or not.

- Note that certain types of bankruptcy court orders are automatically stayed for 10 days, unless the bankruptcy court orders otherwise. These include orders authorizing the use, sale, or lease of property (Bankruptcy Rule 6004(g)), orders authorizing the assignment of executory contracts (Bankruptcy Rule 6006(d)), and an order confirming a chapter 11 plan (Bankruptcy Rule 3020(e)).

- If you cannot obtain a stay, an alternative may be to ask the appellate court for an expedited briefing schedule and expedited treatment of the appeal. Cases where this is justified obviously are limited, but if there is a true need and demonstrable
prejudice would result from things proceeding at the normal speed, you should request an expedited appeal.

- Soon after the appeal is filed, the parties designate the record (Bankruptcy Rule 8006) and the record is then transmitted from the bankruptcy court to the BAP or district court.

- The briefing schedule and other rules concerning briefs and oral arguments are found in Bankruptcy Rules 8009, 8010, and 8012. They provide that the appellant files a brief within 15 days after the appeal is docketed, the appellee files its brief within 15 days after the appellant’s brief is served, and then the appellant has 10 days to reply. This schedule is sometimes modified by court order. The BAP or district court has discretion to hold oral argument or not. See Bankruptcy Rule 8012.

- A party can take further appeal from the BAP or district court’s decision to the court of appeals. BAP and district court decisions on bankruptcy appeals are automatically stayed for 10 days in order to facilitate this. See Bankruptcy Rule 8017(a). If you want a further stay, you need to seek it under Bankruptcy Rule 8017(b). These appeals are governed by the Federal Rules of Appellate Procedure and, as a result, the time limits, briefing rules, etc., differ.

And if you are not happy with the court of appeals’ decision, you can always seek certiorari review in the Supreme Court—although the chances of it being granted aren’t very good.
APPENDIX 21(a)  
CONTINENTAL EN BANC DECISION

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

)  
) IN RE CONTINENTAL AIRLINES:  
)  
) NATIONS BANK OF TENNESSEE, N.A., f/k/a )  
) NationsBank of Tennessee, as  
) Collateral Trustee under a Secured  
) Equipment Indenture and Lease  
) Agreement dated March 15, 1987  ) No. 94-7748  
) ("NationsBank"); NEW JERSEY  
) NATIONAL BANK, as successor by  
) merger to Constellation Bank, N.A.,  
) f/k/a National State Bank of  
) Elizabeth, N.J.; HARRIS TRUST AND  
) SAVINGS BANK; and BOATMAN'S FIRST  
) NATIONAL BANK OF OKLAHOMA, as First,  
) Second and Third Priority Secured  
) Equipment Certificates Trustees  
) thereunder, respectively (the  
) "Series Trustees" and, collectively  
) with NationsBank, the "Trustees"),  
)  
) Appellants  
)

On Appeal from the United States District Court  
for the District of Delaware  
C.A. No. 93-195-JJF  
(Bankruptcy Nos. 90-932 through 90-984)

Argued Sept. 15, 1995

Before: SLOVITER, Chief Judge,  
ALITO and SEITZ, Circuit Judges

Reargued in banc May 14, 1996

Before: SLOVITER, Chief Judge, BECKER, STAPLETON, MANSmann,  
GREENBERG, SCIRICA, COWEN, NYGAARD, ALITO, LEWIS,  
MCKEE, SAROKIN and SEITZ, Circuit Judges

(Filed July 31, 1996)

Gary S. Jacobson (Argued)  
Nicholas J. DiCarlo  
James G. Scotti
Kelley Drye & Warren
New York, NY 10178

Attorneys for Appellant NationsBank
of Tennessee
INTRODUCTION

Before the in banc court is an appeal by NationsBank of Tennessee (Collateral Trustee) and New Jersey National Bank, Harris Trust and Savings Bank, and Boatman's First National Bank of Oklahoma (First, Second, and Third Priority Secured Equipment Certificate Trustees), who are collectively referred to in this opinion as the "Trustees," from the order entered by the district court in the Chapter 11 bankruptcy proceeding of Continental Airlines, Inc. dismissing as "moot" three appeals by the Trustees. Those appeals were from orders of the bankruptcy court which 1) denied the Trustees' Renewed Motion for adequate protection, 2) confirmed Continental's revised second amended joint plan of reorganization, and 3) denied the Trustees' motion for the establishment of a cash deposit of $123,479,287. In essence, the Appellant Trustees seek payment for an asserted administrative
claim of approximately $117 million against the reorganized company. The Appellee, Continental Airlines, Inc., defends the district court's decision to dismiss the Trustees' appeal and argues, in the alternative, that the underlying rulings of the bankruptcy court were correct as a matter of law and fact.

I. FACTUAL AND PROCEDURAL HISTORY

Continental filed its Chapter 11 bankruptcy petition on Dec. 3, 1990. Appellant Trustees serve as successor Collateral and Series Trustees for certificate holders who had provided Continental with operating capital. The certificates were secured at the time of Continental's petition by a pool of 29 commercial aircraft with engines, and 81 additional jet engines which, we were advised, serviced about one-third of Continental's operating fleet. Under the Bankruptcy Code, the debtor in possession, which has most of the rights, powers, functions and duties of a trustee, see 11 U.S.C. § 1107(a), "may use property of the estate in the ordinary course of business without notice or a hearing." 11 U.S.C. § 363(c)(1).

Section 363(e) provides:

Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used . . . by the [debtor in possession], the court, with or without a hearing, shall prohibit or condition such use . . . as is necessary to provide adequate protection of such interest.


On Feb. 21, 1991, First Fidelity Bank of New Jersey, predecessor to NationsBank as Collateral Trustee, filed a motion along with many other aircraft lessors and financiers alleging, inter alia, a decline in the value of the collateral and seeking adequate protection under §363(e). First Fidelity later withdrew from this motion, but on June 28, 1991 it, and the predecessors of the other Appellant Trustees, filed a motion seeking similar relief. The bankruptcy court held an evidentiary hearing on the motion from Sept. 3 through Sept. 6, 1991 limited to the Trustees' assertion that they were entitled to adequate protection payments as a result of the collateral's post-petition decline in market value.

Continental argued, inter alia, that because the Trustees had not filed a motion for relief from the automatic stay, they were not entitled to an award of adequate protection under §363(e). The motion remained pending in the bankruptcy court until August 27, 1992 when the court ruled on the Trustees' motion, rejecting Continental's legal argument but finding as a fact, based on the "Blue Books," a publication issued by a company that appraises aircraft, that the market value of the collateral had not declined during the period at issue in the motion. In re Continental Airlines, Inc., 146 B.R. 536 (Bankr. D. Del. 1992) [hereinafter Continental I].

Approximately two weeks before the bankruptcy court issued that opinion, the Trustees filed their first motion under §362(d) of the Bankruptcy Code to lift the automatic stay ("Lift-Stay Motion"). See 11 U.S.C. § 362(d). This section permits a creditor to move for relief from the automatic stay of delineated activities, such as repossession of collateral, effected by §362(a) of the Bankruptcy Code.
On Sept. 14, 1992, the Trustees also filed a renewed motion for adequate protection for alleged decline in the collateral's value for the period after September 1991, when the original 1991 motion was argued ("Renewed Motion"). There were various hearings on the Renewed Motion between Nov. 3, 1992 and Feb. 5, 1993. Toward the end of that period, the Trustees filed a motion dated Jan. 29, 1993, asking the bankruptcy court to establish a cash deposit of some $123 million, of which $117 million was attributable to alleged market decline, to preserve what the Trustees claimed was the administrative priority status of the Trustees' adequate protection claim if Continental emerged from bankruptcy as a reorganized debtor ("Deposit Motion").

During this period efforts to reorganize the debtor continued. On Nov. 9, 1992 Continental entered into an Investment Agreement under which the Investors (Air Partners, L.P. and Air Canada) agreed and committed to an investment of $450 million in the reorganized entity under a complex arrangement and subject to certain conditions. App. at 391 et seq. One of those conditions, and the one most relevant to this proceeding, was a limitation on the amount and nature of liabilities and administrative expense claims required to be assumed by or attributable to the reorganized company. App. At 408. On Jan. 13, 1993 Continental filed a second amended joint plan of reorganization ("Plan") which referenced that Investment Agreement. The Plan provided, inter alia, for assumption of "allowed administrative claims" by the reorganized Continental. App. at 656.

The confirmation hearing was held for a number of days during the period March 16, 1993 through April 16, 1993. The parties reached a settlement on April 12 concerning adequate protection due to use and/or maintenance of the collateral by Continental, and no issue relating to use decline (the impairment in value attributable to the use of the collateral by the debtor in possession) is before us. However, the parties did not settle the Trustees' adequate protection claims based on decline in market value.

At the conclusion of the confirmation hearing on April 16, 1993, the bankruptcy court denied the Deposit Motion and the Renewed Motion. In a published opinion, the bankruptcy court held that it was necessary for the Trustees to have sought relief from the automatic stay to be entitled to adequate protection for market value decline; that therefore the Trustees were not entitled to adequate protection due to market decline until after the date of their Lift-Stay Motion, i.e. August 14, 1992; and that no decline in the market value of the collateral had taken place since that date. In re Continental Airlines, Inc., 154 B.R. 176 (Bankr. D. Del. 1993) [hereinafter Continental II]. Also on April 16, 1993, the bankruptcy court signed the Confirmation Order. The court made a series of detailed findings of fact and conclusions of law underlying the Confirmation Order which will be referred to throughout this opinion when pertinent.

On April 20, 1993 the Trustees filed three notices of appeal to the district court from the bankruptcy court's denial of the Renewed Motion for Adequate Protection, its denial of the Deposit Motion, and its order confirming the Plan. Two days later, the Trustees filed a motion for a partial stay of the consummation of the Plan ("Conditional Stay Motion"), but filed that motion in the district court, which referred them to the bankruptcy court. On April 26, 1993, the Trustees filed that stay request in the bankruptcy court. Because the bankruptcy judge was not available, the
hearing on the motion was held the next day in the district court, which stated, without explanation or analysis, that the Trustees were likely to prevail on their appeal to the district court, but denied the stay because the Trustees were "unable to post a bond satisfactory to the Court." App. at 1755-56. The Trustees did not then make any effort to seek any emergency relief from this court. With no stay impeding implementation of the Plan which had now been confirmed, the Investors proceeded to close the transaction by making their promised investment.

On May 6, 1993 Continental filed a motion in the district court to dismiss the Trustees' appeals as moot, which the district court granted on Dec. 30, 1993. The Trustees filed a motion for rehearing and reconsideration in light of the decision in Frito-Lay, Inc. v. LTV Steel Co., Inc. (In re Chateaugay Corp.), 10 F.3d 944 (2d Cir. 1993) [hereinafter Chateaugay II], which the court denied. The Trustees then filed a timely notice of appeal. This court has jurisdiction pursuant to 28 U.S.C. _ 158(d).

A panel of this court heard argument on Sept. 15, 1995 and issued an opinion that affirmed the district court's order by a two-to-one vote. The Trustees petitioned for rehearing, and the in banc court voted to rehear the appeal. Under this court's Internal Operating Procedures, the opinion of the panel issued Feb. 7, 1996 was withdrawn.

II. DISCUSSION

A. This court has not addressed the interesting and challenging questions raised by the bankruptcy court's holding that a creditor must file a motion to lift the automatic stay as a prerequisite to seeking adequate protection. The Trustees argue that the bankruptcy court erred as a matter of law and that this court can decide the issue de novo even though it was not reached by the district court. They further argue that the bankruptcy court's finding that there was no diminution in the market value of the Trustees' collateral after they filed their Lift-Stay Motion was clearly erroneous. Finally, they argue that the bankruptcy court erred as a matter of law in denying their motion for the establishment of a cash deposit.

Not surprisingly, Continental, as appellee, defends both the bankruptcy court's legal determination that the Trustees could not assert adequate protection claims for alleged market value decline during the period before they moved for relief from the automatic stay and its factual conclusion that there had been no substantial decline in the value of the collateral since the Lift-Stay Motion was filed. Finally, it argues that in any event the Trustees could not recover for adequate protection because the value of the collateral did not decline below its value on the petition date, which Continental contends is the relevant measure.

We would reach these issues only if we were satisfied that the district court erred in holding that the Trustees' appeals to it were "moot," a decision as to which the parties vigorously disagree. Mootness vel non of the appeals before the district court is closely related to, if not indistinguishable from, the question whether the appeal to this court is moot, an issue which Continental alludes to in its brief. For convenience, we will refer to mootness in the district court unless we state otherwise.

Continental does not contend that the appeals to the district court or to us were moot in the constitutional sense, implicating the case or
controversy requirement of Article III, This is not a situation analogous to those where the Supreme Court determined that the appeals became moot because the law at issue was repealed, see Diffenderfer v. Central Baptist Church, 404 U.S. 412, 414-15 (1972); the subject of the election campaign controversy was no longer a candidate, see Golden v. Zwicker, 394 U.S. 103, 109-10 (1969); or the railroad whose application for tariffs was contested withdrew that application, see A.L. Mechling Barge Lines, Inc. v. United States, 368 U.S. 324, 329-30 (1961).

Indeed, as the Supreme Court has recently explained, an appeal is moot in the constitutional sense only if events have taken place during the pendency of the appeal that make it "impossible for the court to grant 'any effectual relief whatever.'" Church of Scientology v. United States, 506 U.S. 9, 12, 113 S. Ct. 447, 449 (1992) (quoting Mills v. Green, 159 U.S. 651, 653 (1895)). An appeal is not moot "merely because a court cannot restore the parties to the status quo ante. Rather, when a court can fashion 'some form of meaningful relief,' even if it only partially redresses the grievances of the prevailing party, the appeal is not moot." RTC v. Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group, Inc.), 16 F.3d 552, 560 (3d Cir. 1994) (in banc) (quoting Church of Scientology, 113 S. Ct. at 450). Thus, in Isidor Palewonsky Associates v. Sharp Properties, Inc., 998 F.2d 145, 152 (3d Cir. 1993), we concluded that because we could impose at least one of the remedies enumerated by the appellant, and thereby provide it "some effective relief," the appeal was not moot. See also Swedeland, 16 F.3d at 559-60. That is not the issue in this case.

Instead, Continental invokes the broader interpretation of mootness applied in bankruptcy cases, often referred to as "equitable mootness." See, e.g., Manges v. Seattle-First Nat'l Bank (In re Manges), 29 F.3d 1034, 1038-39 (5th Cir. 1994), cert.denied, 115 S. Ct. 1105 (1995); In re Specialty Equip. Cos., 3 F.3d 1043, 1048 (7th Cir. 1993); Official Comm. of Unsecured Creditors of LTV Aerospace & Defense Co. v. Official Comm. Of Unsecured Creditors of LTV Steel Co. (In re Chateaugay Corp.), 988 F.2d 322, 325 (2d Cir. 1993) [hereinafter Chateaugay I]; Rochman v. Northeast Utila. Serv. Group (In re Public Serv. Co.), 963 F.2d 469, 471-72 (1st Cir.), cert. denied, 506 U.S. 908 (1992); First Union Real Estate Equity & Mortgage Invs. v. Club Assocs. (In re Club Assocs.), 956 F.2d 1065, 1069 (11th Cir. 1992); Central States, Southeast and Southwest Areas Pension Fund v. Central Transp., Inc., 841 F.2d 92, 95-96 (4th Cir. 1988); In re AOV Indus., 792 F.2d 1140, 1147 (D.C. Cir. 1986); Trone v. Roberts Farms, Inc. (In re Roberts Farms, Inc.), 652 F.2d 793, 796-97 (9th Cir. 1981). Under this widely recognized and accepted doctrine, the courts have held that "[a]n appeal should . . . be dismissed as moot when, even though effective relief could conceivably be fashioned, implementation of that relief would be inequitable." Chateaugay I, 988 F.2d at 325. The use of the word "mootness" as a shortcut for a court's decision that the fait accompli of a plan confirmation should preclude further judicial proceedings has led to unfortunate confusion. In a trenchant discussion of the issue in a recent decision of the Seventh Circuit, the court noted that denominating the doctrine as "equitable mootness" is misleading. In re UNR Indus., 20 F.3d 766, 769 (7th Cir.), cert. denied, 115 S. Ct. 509 (1994). Judge Easterbrook,

1See, e.g., Preiser v. Newkirk, 422 U.S. 395, 401-02 (1975).
writing for the court, stated: "[t]here is a big difference between inability to alter the outcome (real mootness) and unwillingness to alter the outcome ('equitable mootness'). Using one word for two different concepts breeds confusion." Id. (emphasis in original). Thus, although the discussions and applications of the concept of "mootness" in bankruptcy cases by that court had previously encompassed what is referred to elsewhere as "equitable mootness," see Specialty Equip., 3 F.3d at 1048; In re Andreuccetti, 975 F.2d 413, 418 (7th Cir. 1992), the court in UNR Industries stated it would now "banish 'equitable mootness' from the (local) lexicon." 20 F.3d at 769. Instead, the court continued, "[w]e ask not whether this case is moot, 'equitably' or otherwise, but whether it is prudent to upset the plan of reorganization at this late date." Id.

These "equitable" or "prudential" considerations focus on "concerns unique to bankruptcy proceedings." Manges, 29 F.3d at 1038. It is evident that "equitable mootness" is an inapt description of the doctrine at issue here. Nonetheless, since past cases have used that term, we use it in discussing them. Therefore, it does not further consideration of this appeal to argue, as the dissent does, that we have "fallen into the trap" of confusing these considerations with Article III mootness. Whether termed "equitable mootness" or a prudence doctrine, we see no reason why the Third Circuit should part company with our sister circuits in their adoption of this doctrine. If limited in scope and cautiously applied, this doctrine provides a vehicle whereby the court can prevent substantial harm to numerous parties.

The Trustees have not challenged the viability of the doctrine of equitable mootness or application of prudential considerations in bankruptcy cases, nor have they cited to a case in any circuit that rejects the concept. Instead, they rely most heavily on a decision of the Second Circuit holding that even though the reorganization plan for the bankrupt LTV Corporation had been confirmed, the appeal of tax lessors challenging the plan's failure to give their claims administrative priority was not moot. See Chateaugay II, 10 F.3d 944 (2d Cir. 1993). Significantly, the court in Chateaugay II did not quarrel with the doctrine, merely its application in that case. In fact, in RTC v. Best Products Co. (In re Best Products Co.), 68 F.3d 26, 29 (2d Cir. 1995), a more recent case from the Second Circuit, the court once again emphasized the language in Chateaugay I that even though an appeal may not be moot in the sense of Article III of the Constitution, it may be deemed moot in bankruptcy cases because of "equitable considerations."

We have generally stated that we exercise plenary review of a district court's decision on mootness. See Swedeland, 16 F.3d at 559; Northeast Women's Ctr., Inc. v. McMonagle, 939 F.2d 57, 61 (3d Cir. 1991); International Bhd. Of Boilermakers v. Kelly, 815 F.2d 912, 914 (3d Cir. 1987). However, none of those cases involved a determination, like the one we review here, that an appeal following a consummated bankruptcy reorganization should be dismissed for equitable and prudential reasons even though some effective relief is available. Surprisingly, we have seen little more than a few cursory references to the standard of review in the cases from other circuits applying this doctrine. See AOV Indus., 792 F.2d at 1148 (district court's power to dismiss appeal as moot "discretionary"); Club Assocs., 956 F.2d at 1069 (legal determinations reviewed de novo, bankruptcy court's factual findings reviewed for clear error).
Because the mootness determination we review here involves a discretionary balancing of equitable and prudential factors rather than the limits of the federal courts' authority under Article III, using ordinary review principles we review that decision generally for abuse of discretion. Cf. General Glass Indus. Corp. v. Monsour Medical Found., 973 F.2d 197, 200 (3d Cir. 1992) (abstention determination reviewed under abuse of discretion standard); Bermuda Express, N.V. v. M/V Litsa, 872 F.2d 554, 557 (3d Cir.) (balancing of equities involved in application of laches doctrine reviewed for abuse of discretion), cert. denied, 493 U.S. 819 (1989); Bennett v. White, 865 F.2d 1395, 1402 (3d Cir.) (scope of a remedial order reviewed for abuse of discretion), cert. denied, 492 U.S. 920 (1989); Evans v. Buchanan, 555 F.2d 373, 378-79 (3d Cir.) (in banc) (same), cert.denied, 434 U.S. 880 (1977). A particular case may also raise legal and/or factual issues interspersed with the prudential ones, and then the applicable review standard, plenary or clearly erroneous, will apply.

The dissent argues that the cases cited above are inapposite because the district court acted as an appellate court and that we should therefore use plenary review. However, the proposition that when an appellate court reviews a lower court's balancing of prudential factors, it does so under an abuse of discretion standard as long as the factors considered are not inappropriate as a matter of law is a general one applicable in all fields, not excluding bankruptcy. As the Fifth Circuit noted in a bankruptcy case:

In this particular case, we are reviewing the decision of the district court in its capacity as an appellate court. Several different standards of review govern our decision, depending on the nature of the holdings reviewed. Where the disputed holding involves a matter that is within the district court's discretion, we will affirm the judgment of a district court acting in its appellate role unless the court has clearly abused its discretion.

Matter of HECI Exploration Co., Inc., 862 F.2d 513, 519 (citations omitted).

B. Factors that have been considered by courts in determining whether it would be equitable or prudential to reach the merits of a bankruptcy appeal include (1) whether the reorganization plan has been substantially consummated, (2) whether a stay has been obtained, (3) whether the relief requested would affect the rights of parties not before the court, (4) whether the relief requested would affect the success of the plan, and (5) the public policy of affording finality to bankruptcy judgments. See Manges, 29 F.3d at 1039; Rochman, 963 F.2d at 471-72. The Trustees have not taken issue with our identification of these factors.

Although these five factors have been given varying weight, depending on the particular circumstances, the foremost consideration has been whether the reorganization plan has been substantially consummated. This is especially so where the reorganization involves intricate transactions, see Rochman, 963 F.2d at 473-74 (performance under plan involved "numerous complex arrangements"); Roberts Farms, 652 F.2d at 797 (plan involved "many intricate and involved transactions" and reversal of plan's confirmation "would knock the props out from under" such transactions and "create an unmanageable, uncontrollable situation for the Bankruptcy Court"), or where outside investors have relied on the confirmation of the plan, see Manges, 29 F.3d at 1039 (equitable mootness "protects the interests of non-adverse third parties who are not before the reviewing court but who have acted in reliance
"Substantial consummation" is defined in the Bankruptcy Code as: "(A) transfer of all or substantially all of the property proposed by the plan to be transferred; (B) assumption by the debtor or by the successor to the debtor under the plan of the business or of the management of all or substantially all of the property dealt with by the plan; and (C) commencement of distribution under the plan." 11 U.S.C. § 1101(2). In such instances, the strong public interest in the finality of bankruptcy reorganizations is particularly compelling.

The district court dismissed the Trustees' appeals to it as "moot" based on the conclusions, set forth in its opinion dated Dec. 30, 1993, that substantial consummation of the Plan had occurred, the Investors had already made their $450 million investment into the reorganized entity, all elements of the Plan, except distributions to the unsecured creditors, had been completed, and a reversal of the order confirming the Plan likely would put Continental back into bankruptcy. App. at 1873. The court also noted that Continental had implemented the Plan following its approval by the court because the Trustees had failed to obtain a stay.

The Trustees do not challenge that there had been substantial consummation by December 1993, when the district court dismissed the appeals as moot. They suggest that as their object is not to disturb the reorganization, but only to get payment from the reorganized Continental for their adequate protection claim measured by the market value decline of the collateral during bankruptcy, the line of cases upon which Continental relies is inapplicable. We cannot agree, because the rejection of the Trustees' claim by the bankruptcy court was inextricably intertwined with the implementation of the reorganization. See AOV Indus., 792 F.2d at 1148 (to evaluate mootness, court must "scrutinize each individual claim, testing the feasibility of granting the relief against its potential impact on the reorganization scheme as a whole"). Thus, the Trustees cannot avoid the effect of the substantial consummation of the reorganization plan so readily.

Inasmuch as Continental agrees that the issue is not constitutional mootness but prudential mootness, we will assume arguendo that even after substantial or total consummation of its reorganization, some effective relief would have been available for the Trustees' claim at the time they appealed to the district court, and on appeal to this court. Even before the in banc court, Continental has not challenged that assumption. It is quite another matter in light of the substantial, indeed irrevocable, change in the status quo that followed confirmation to determine that it would have been prudent for the court to reach the merits of the Trustees' claim. For the district court had before it an unstayed bankruptcy reorganization plan, and many courts have based their prudential decisions to decline to consider challenges to bankruptcy court orders on the ground that there has been substantial consummation of a plan of reorganization in reliance upon an unstayed confirmation order. See, e.g., Rochman, 963 F.2d at 475.
In Chateaugay I, the court noted that although the Bankruptcy Code only requires a stay pending appeal in limited circumstances, there is a procedure under Bankruptcy Rule 8005 to seek to preserve the status quo and "[t]he party who appeals without seeking to avail himself of that protection does so at his own risk." 988 F.2d at 326. And in In re Manges, the court observed, under the descriptive title "Halting the Runaway Train: the Motions to Stay," that "in many of the cases in which bankruptcy appeals were dismissed as moot, the appellants failed to seek a stay." 29 F.3d at 1039.

Even the seeking of a stay may not be enough. The appellants in In re UNR Industries had sought a stay, albeit unsuccessfully, at every opportunity; nonetheless, the court noted, "[a] stay not sought, and a stay sought and denied, lead equally to the implementation of the plan of reorganization." 20 F.3d at 770; accord AOV Indus., 792 F.2d at 1144, 1146-47.

Shortly after the confirmation of the Continental Plan, the Trustees filed an Emergency Motion for Conditional Stay of Order Confirming the Plan pending their appeal to the district court. The condition the Trustees sought in lieu of a stay was the establishment of a segregated account for $117 million, the full amount of their adequate protection claim, or alternatively at least $22 million, which they claim was the admitted decline in the value of the collateral. See App. at 1721. In response to the district court's inquiry, they conceded that they were not willing to post any bond. The district court never required a supersedeas bond in the amount of $450,000,000, as the Trustees have suggested. In fact, the district court tried to ascertain the amount of bond that would be reasonable, and the Trustees' general position was that they were "merely the fiduciary of the money of their bondholders" and they suggested no lesser amount. App. at 1729.

Thus, as one of the reasons for its order denying the stay, the district court noted the unwillingness of the Trustees to post a bond satisfactory to the court. App. at 1756. See, e.g., Central States, 841 F.2d at 95 (appellant's failure to post bond to stay confirmation order basis for finding appeal moot). Because the failure to post the bond needed to get a stay permitted the consummation of the plan, this factor weighs heavily in favor of the district court's declination to delve into the merits of the Trustees' appeal.

The Trustees argue that this court has held that failure to obtain a stay does not necessarily render an appeal moot. The cases to which they refer are not apposite. In one, In re Joshua Slocum Ltd., 922 F.2d 1081 (3d Cir. 1990), the issue was the narrow one of the power of the bankruptcy court to excise a paragraph from a shopping center lease. There is no indication in Slocum that there had been any confirmation of a plan before or during the appeal.

In the more recent case to which the Trustees refer, Megafoods Stores, Inc. v. Flagstaff Realty Assoc. (In re Flagstaff Realty Assoc.), 60 F.3d 1031 (3d Cir. 1995), the appeal also presented a narrow landlord-tenant issue, i.e. the effect of confirmation of the landlord's plan on a tenant's right to pursue its appeal of the bankruptcy court's denial of its recoupment claim. In holding that it was not necessary for the tenant to seek a stay in order to pursue its right to appeal despite the confirmation in the interim,
Appendix 21(a) - Continental en banc Decision

we noted the line of cases placing recoupment and setoff in a special category and stated, "although we recognize the importance of maintaining the integrity of confirmed plans from later attack, these unique circumstances permit the plan to be reopened and readjusted." *Id.* at 1036. Thus, neither Flagstaff nor Slocum addressed the equitable or prudential mootness considerations at issue here.

High on the list of prudential considerations taken into account by courts considering whether to allow an appeal following a consummated reorganization is the reliance by third parties, in particular investors, on the finality of the transaction. See *Manges*, 29 F.3d at 1039 ("[t]he concept of 'mootness' from a prudential standpoint protects the interests of non-adverse third parties who are not before the reviewing court but who have acted in reliance upon the plan as implemented"); *Rochman*, 963 F.3d at 474-75 (similar). Here, the record is replete with evidence that the Investors relied on the bankruptcy court's unstayed Confirmation Order in making the decision to proceed to close the transaction and that an essential factor in that decision was the bankruptcy court's disallowance of the Trustees' adequate protection claim.

The Plan of reorganization provided that the reorganized Continental would pay "Allowed Administrative Claims." App. at 656, 691 (Plan __ 5.5, 10.1). Among the administrative claims that were still disputed at the time of the confirmation hearing were several large claims, including, in particular, labor claims by airline pilots, large claims by Eastern Airlines, and the Trustees' claim for adequate protection based on alleged market decline of the collateral. App. at 1223, 1346. One of the concerns of the Investors that needed to be satisfied as a condition of their participation was that the total amount that would have to be paid for allowed administrative claims could be distorted by a few such large claims. To limit their exposure, the Investment Agreement provided that the Investors' obligation to proceed with the arrangements was subject, inter alia, to the payments and obligations for administrative claims being no higher than a specified amount, or "cap." App. at 408.

At the confirmation hearing, Continental's expert witness testified that if the claims of the Airline Pilots and the Trustees were excluded, the total allowed administrative claims payable under the Plan would be close to the cap, and that if the Trustees' claim were allowed, the cap would be exceeded, allowing the Investors to walk away from the deal. App. at 1223-24, 1333-38. Based on this testimony, Continental argued to the bankruptcy court that the feasibility determination required for confirmation under 11 U.S.C. __ 1129(a)(11) would turn in part on the adjudication of the Trustees' still outstanding administrative claim. App. at 1400. Continental therefore urged the court to incorporate its adjudication of the Trustees' claim into the Confirmation Order itself, asserting that the Investors would not go forward with the deal "unless there is an order upon which they can place reliance, which is going to be a plan confirmation order." App. at 1400. The Trustees argued against incorporation, taking the position that even though the amount of the adequate protection claim allowed by the court would be relevant to the court's subsequent determination of feasibility, the adjudication of the claim itself was a separate matter from plan confirmation. App. at 1401.

The bankruptcy court ultimately took the approach urged by Continental, incorporating into its Confirmation Order its decision denying the Trustees' adequate protection claim. As part of its feasibility
determination, it explicitly found that neither the pilots' claims nor the Eastern claims was entitled to administrative priority, and that the Trustees' adequate protection claim had no value as an administrative claim. App. at 1549-51. On that basis, it found that there was substantial, credible and uncontested evidence that the administrative claims payable at confirmation -- excluding the claims of the pilots, Eastern, and the Trustees -- would be within the specified limit of the cap set forth in the Investment Agreement, App. at 1548, noting that the adjudications of the Trustees' claim and the Eastern claims were "crucial to the willingness of the Investors to consummate the Financing Transaction." App. at 1550.

We are unwilling to accept the Trustees' suggestion, implicit in their briefs and made explicit at oral argument, that the bankruptcy court's ruling on the merits of their adequate protection claim was colored by a so-called "ultimatum" from Continental that if the claim were granted the Investors would abandon the reorganization. See In Banc Argument Transcript at 3. The Trustees offer no evidence in support of this suggestion, and we certainly would not lightly impute such a motive to the bankruptcy court. In effect, the Trustees are challenging the Investors' right to condition their investment on the amount of approved administrative claims. This was never raised below at the time of the Investment Agreement, the ultimate confirmation or the period between. We know of no statute, rule or precedent that would deny investors the right to limit their investments on the existence of conditions which they believe give the newly reorganized company a reasonable opportunity to succeed -- such as, in this case, without being weighed down by excessive administrative expenses.

The Trustees also argue that Continental's position at the confirmation hearing, that the adjudication of the Trustees' claim should be incorporated into the Confirmation Order, was a "ploy" to "disingenuously" use the fact of such incorporation to "manufactur[e] the appearance of mootness." Appellants' Brief at 3; In Banc Argument Transcript at 1. Their characterization of Continental's position as a "ploy" implies that it had no legitimate reason. In light of the integral nexus between the feasibility of confirmation and the adjudication of the Trustees' claim, it appears that the suggestion of incorporation urged by Continental and adopted by the bankruptcy court was reasonable and reflected the inescapable fact that the Trustees' claim and the confirmation of the Plan were inextricably intertwined, rather than an attempt to "manufacture" the appearance of equitable mootness.

In dismissing the Trustees' appeals as moot, the district court specifically found that the Investors had relied on the bankruptcy court's unstayed Confirmation Order and that there was an integral nexus between the investment and the success of the Plan. The court stated, "[t]he Investors relied on the unstayed Confirmation Order in making the $450 million investment in Continental's Plan. It is clear that [the Trustees'] requested relief would undermine the grounds which the Investors relied upon in making their investment and would require a dismantling of the entire Plan." App. at 1874. Although the Trustees argue that this finding is erroneous, there is support for it in the record.

At the hearing in April 1993 before the district court on the Trustees' request for the conditional stay of the Confirmation Order, counsel for the Trustees stated they had testimony that "as a matter of business judgment, it would be extremely unlikely for the investors to walk away from this deal if..."
a 22-million-dollar deposit was established."

The Trustees' counsel in effect challenged the Investors to assert otherwise, stating that inasmuch as the Investors' counsel were in court they could correct any assertions that he made. Id. Thereafter, the Investors' attorney rose "to make clear the [Investors'] position, which is that if the relief is granted to [the Trustees] which they seek from the Court this morning [the stay conditioned on a deposit of some $22 million to $117 million], then we are not prepared to close the transaction." App. at 1744.

The representative of the Investors explained that in the airline business "there is a great sensitivity to cash and the capital structure of a reorganized entity," and that the relief that the Trustees sought "could significantly impair the capital structure that would exist with respect [to] this reorganized airline." Id. at 1744-45. He reviewed the negotiations that had occurred for the cap for administrative expense liability, advised that the Investors had monitored on a monthly basis Continental's performance in that respect, and explained that the Investors had insisted that the Confirmation Order address the issue of the Trustees' claim "because we want to make sure if we are putting our money in, we are getting the benefit of our bargain, which is a reorganized entity with a capital structure that we contemplated." App. at 1746. He concluded by stating unequivocally that if a stay were entered conditioned upon the bond the Trustees sought, then his client "would not be prepared to close this transaction." Id. The Trustees' counsel did not thereafter argue that the Investors' counsel's statements were insufficiently probative, and therefore that suggestion here is less than persuasive. The Trustees have not contested here that if their claim for market value decline of the collateral (a claim independent of their claim for the use and maintenance of the collateral, which has been satisfied) had been approved as an administrative claim, the total such administrative claim would have greatly exceeded the cap specified by the Investors for that purpose. This would have given the Investors the option to withdraw; such withdrawal would have placed the entire Plan in jeopardy. By the time the district court ruled on the appeal, it was no longer possible to restore the parties to their earlier positions because the investment had been made, and the option to withdraw was no longer available to the Investors. See Specialty Equip., 3 F.3d at 1049 (claim held moot when its acceptance "would amount to imposing a different plan of reorganization on the parties"). Thus, the third factor bearing on the prudential determination whether to reach the merits of a bankruptcy appeal after confirmation and in the absence of a stay -- the effect of the requested relief on the rights of parties not before the court -- weighs heavily against the Trustees.

This factor cannot fairly be recast as whether the Investors or others reasonably relied on the prediction that the Trustees would recover nothing on their claim. While we agree that reliance of the Investors and others on the unstayed Confirmation Order is of central importance to our analysis, to focus on the "reasonableness" of that reliance, at least as measured by the likelihood of reversal on appeal, is necessarily a circular enterprise and therefore of little utility. Whether the Investors were reasonable in relying on the bankruptcy court's order depends on whether this was a case that would be considered on the merits on appeal or would be dismissed on the basis of the doctrine often referred to as "equitable mootness." And whether this case would be dismissed on "equitable mootness" grounds on appeal in turn depends on whether the Investors reasonably relied. Thus, placing the focus on the reasonableness of the Investors' reliance as measured by the probability that
Continental would prevail on appeal sets up a straw man which is easily knocked down.

Our inquiry should not be about the "reasonableness" of the Investors' reliance or the probability of either party succeeding on appeal. Rather, we should ask whether we want to encourage or discourage reliance by investors and others on the finality of bankruptcy confirmation orders. The strong public policy in favor of maximizing debtors' estates and facilitating successful reorganization, reflected in the Code itself, clearly weighs in favor of encouraging such reliance. Indeed, the importance of allowing approved reorganizations to go forward in reliance on bankruptcy court confirmation orders may be the central animating force behind the equitable mootness doctrine. See Rochman, 963 F.2d at 471-72; Metro Property Mgmt. Co. v. Information Dialogues, Inc. (In re Information Dialogues, Inc.), 662 F.2d 475, 477 (8th Cir. 1981). Where, as here, investors and other third parties consummated a massive reorganization in reliance on an unstayed confirmation order that, explicitly and as a condition of feasibility, denied the claim for which appellate review is sought, the allowance of such appellate review would likely undermine public confidence in the finality of bankruptcy confirmation orders and make successful completion of large reorganizations like this more difficult. This is true regardless of whether the Investors' reliance was "reasonable" or based on a 30 percent, 60 percent, or 100 percent probability of success on appeal, an issue raised at the oral argument.

In arguing against dismissal here on the basis of prudential considerations, the Trustees repeatedly rely on their assertion that the Plan contained "a built-in mechanism for the [post-confirmation] disposition and payment of Disputed Administrative Claims." Appellants' Brief at 10. On the basis of this provision, they argue that they had no obligation to take steps to preserve the status quo through a stay, that their appeal is not moot because "some effective relief" is available, and that the Plan is contractually "binding" on Continental. They conclude that the district court therefore erred in "permit[ting] Continental to escape its 'contractual' obligations under the Plan under the guise of the mootness doctrine." Appellant's Brief at 20. While the Trustees' description of the "mechanism" provided in the Plan is technically correct, they overstate the impact of that mechanism.

Under the definitions in the Plan, the Trustees' claim was a "Disputed Administrative Claim" because it sought adequate protection payments, see App. at 623-24 (Plan _ 1.4(vi)) and was the subject of a timely objection, see App. at 632 (Plan _ 1.85(a)). The Plan requires the reorganized Continental to pay allowed administrative claims on the later of: the effective date of confirmation or "the fifth Business Day after such Claim is Allowed." App. at 691 (Plan _ 10.1). Further, the Plan provides that "[a] Disputed Claim shall be an Allowed Claim if, and only to the extent that, such Disputed Claim has been Allowed by a Final Order," App. at 623 (Plan _ 1.5), and defines a "Final Order" as "[a]n order which is no longer subject to appeal, certiorari proceeding or other proceeding for review or rehearing, and as to which no [such proceeding is] pending," App. at 635 (Plan _ 1.100).

Thus, the Plan imposes an obligation on the reorganized. Continental to pay disputed administrative claims once they become allowed by a final order of court, even if such final order does not occur until after confirmation. If the bankruptcy court's disallowance of the Trustees' claim
were to be reversed on appeal, the Plan appears to provide a "mechanism" for payment of the claim by the reorganized Continental. The mere availability of such a mechanism, however, which may prevent dismissal on the ground of Article III constitutional mootness, does not warrant reversal of the district court's order dismissing it on prudential grounds. As we have noted, the district court's "mootness" determination was based not on a finding that no effective relief was available, but rather on the finding that in light of all the circumstances, it would be inequitable to grant relief. Nor has any "contractual obligation" been violated either by Continental or the district court. Where, as here, there has been no order, final or otherwise, allowing the Trustees' disputed administrative claim, the Plan imposes no obligation on the reorganized Continental to pay it.

Finally, the Plan provisions allowing for post-confirmation payment of allowed claims in no way obviated the Trustees' obligation to seek a stay. Here, where the confirmation of the Plan and the willingness of the Investors to go forward turned on the bankruptcy court's denial of the Trustees' claims, and where the denial of those claims was in fact incorporated into the Confirmation Order, there was a clear possibility that the Trustees' claims would become moot after consummation of the Plan, and it was therefore incumbent on the Trustees to obtain a stay. Indeed, the record shows that all parties were well aware of the extensive legal precedent dismissing as moot or on equitable grounds appeals from unstayed consummated reorganizations. See App. at 410 (references in the Investment Agreement); App. at 1729-30, 1741 (argument before the district court on the stay).

For similar reasons, we fail to see the inconsistency charged by the Trustees between Continental's current position as to "equitable mootness" and its argument to the bankruptcy court in response to the Trustees' Deposit Motion that the Plan would require payment of the Trustees' claim by the reorganized Continental if and when allowed. See App. at 1039. As noted above, the Plan imposes no obligation on Continental in the absence of a final order allowing the Trustees' claim, and the mere availability of a mechanism for granting relief does not mean the court cannot determine that in light of all the circumstances it should not even try to unscramble the eggs.

Moreover, at the time Continental argued against the Deposit Motion the bankruptcy court had not yet ruled disallowing the Trustees' claim nor cited that as an explicit basis for its feasibility determination in confirming the plan. Accordingly, Continental did not yet have reason to know that the claim would be denied and become subject to "equitable mootness" on appeal. As soon as the basis for this mootness argument became apparent, Continental repeatedly asserted its intention to make such an argument if an appeal was filed and no stay obtained. App. At 1691, 1742.

The Trustees have not presented us with any arguments which would weigh against all of the prudential considerations that dictate that this consummated reorganization must be left in place. Following confirmation, Continental was operating as a restructured company, and had entered into countless new relationships and transactions. To convince a court to take the action sought by the Trustees which would undermine the basis for the Investors' decision to proceed, the Trustees would have to proffer a powerful reason indeed. They have not even attempted to do so.
Arrayed against that silence are the facts that the reorganization plan was consummated, no stay was obtained, numerous other parties have changed their positions, and numerous irrevocable transactions have since been completed as a result of the consummation of the Plan. Without listing all of such transactions set forth by Continental in its brief, we note that among those are the distribution to unsecured creditors, the merger of 53 debtors other than Continental with and into Continental, the investment of $110 million in cash by Air Partners and Air Canada in the reorganized Continental, the transfer by foreign governments of various route authorities, and the assumption by the reorganized Continental of unexpired leases and executory contracts worth over $5.0 billion. Thus, the key issue really is whether the district court abused its discretion in weighing the various equitable factors. We are not prepared to hold that the balance reached by the district court was an abuse of its discretion.

Under the circumstances presented here, we can see no prudential considerations that would support an attempt by an appellate court, district or court of appeals, to fashion even a limited remedy for the Trustees. That would necessarily entail imposing a new debt on the reorganized company, which is a different entity than it was when this case was before the district court. Thus, we agree with the determination of the district court to dismiss the Trustees' claim. We base our holding on our conclusion that it would be neither prudent nor equitable to grant the Trustees the relief they seek.

III. CONCLUSION

For the reasons set forth we will affirm the order of the district court.

In Re: Continental Airlines
No. 94-7748

ALITO, Circuit Judge, dissenting, joined by Judges Becker, Greenberg, Lewis, McKee and Sarokin.

The majority's decision in this case creates a bad precedent for our circuit. The majority adopts the curious doctrine of "equitable mootness," which it interprets as permitting federal district courts and courts of appeals to refuse to entertain the merits of live bankruptcy appeals over which they indisputably possess statutory jurisdiction and in which they can plainly provide relief. According to the majority, there is no clear rule for determining when a bankruptcy appeal is "equitably moot." Instead, this is said to be a discretionary determination to be made in the first instance by the district court based on a weighing of five factors that the majority has culled from the opinions of our "sister circuits." In my view, if the doctrine of "equitable mootness" has any validity, it is more limited than the majority holds.

The dangers inherent in the majority's adoption and broad interpretation of this doctrine are illustrated by this case. In simple terms, this is what happened. After filing for relief under Chapter 11 of the Bankruptcy Code, Continental Airlines continued to use certain aircraft and jet engines that were held as collateral entrusted to the Trustees. Believing
that their collateral was undergoing a dramatic diminution in value, the Trustees in August 1992 filed a renewed motion in the bankruptcy court seeking "adequate protection" under 11 U.S.C. §363(e). During the next eight months, while the Continental reorganization plan proceeded toward confirmation, the bankruptcy court did not rule on this motion. In March 1993, Continental insisted that the bankruptcy court rule on the Trustees' motion at the same time that it confirmed the plan, and Continental told the bankruptcy judge that unless the motion was denied, the prospective investors in the reorganized corporation would withhold funding, and the reorganization would not go forward. See Continental Br. at 5-6 & n.1. Furthermore, Continental took the position that if the plan was confirmed and went into effect, any appeal would be moot. See Continental Br. at 21. The bankruptcy court then simultaneously denied the Trustees' motion and entered the order confirming the plan. The Trustees exercised their statutory right to appeal to the district court, and in my view the need for review by an Article III court is particularly acute when the challenged ruling of the bankruptcy court is made under circumstances such as these.

The Trustees, however, have been utterly denied such review. In the initial level of appeal, the district court opined that the Trustees probably would have won if the merits of their appeal had been reached (JA 1755-56), but the district court dismissed their appeal as moot. Likewise, the majority of our court describes the Trustees' arguments as "interesting and challenging" (Maj. Op. at 9) but then throws them out of court without reaching the merits of their arguments. And the majority does this even though (a) this case is clearly not "moot" in any proper sense of the term, (b) we unquestionably have statutory jurisdiction, and (c) we have a "virtually unflagging obligation" to exercise the jurisdiction that we have been given. Colorado River Water Conservation District v. United States, 424 U.S. 800, 817 (1976). I am puzzled and troubled by what the majority has done.

I.

As the majority notes, the Trustees have not contested the existence of the doctrine of "equitable mootness," and in light of the Trustees' position, I think that it is appropriate to assume the existence of this doctrine for purposes of this appeal. The majority opinion, however, does not simply assume the existence of this doctrine but adopts it as part of the law of our circuit. In doing so, the majority does not undertake an independent analysis of the origin or scope of the doctrine but is instead content to rely on the decisions of other courts of appeals. From these decisions, the majority extracts five factors, which are to be weighed by the district court in the initial level of appeal for the purpose of determining whether the appeal is "equitably moot." Maj. Op. at 14. These factors are: "(1) whether the reorganization plan has been substantially consummated, (2) whether a stay has been obtained, (3) whether the relief requested would affect the rights of parties not before the court, (4) whether the relief requested would affect the success of the plan, and (5) the public policy of affording finality to bankruptcy judgments." Maj. Op. at 15.

I am not convinced that the majority's test is consistent with the law of all of the circuits that the majority claims to be following. For example, the Eleventh Circuit holds that the proper test is "whether the reorganization plan has been so substantially consummated that effective relief is no longer available." In re Club Associates, 956 F.2d 1065, 1069
This inquiry seems quite different from the majority's indeterminate five-factor test. But even if the majority's analysis is supported by the decisions it cites, and even though I think that those decisions deserve careful and respectful consideration, I think that the in banc majority should have made an independent examination of the basis and scope of the doctrine of "equitable mootness" before engraving it in our circuit's law.

What is the basis of this doctrine? As the majority acknowledges, it does not stem from the "case-or-controversy" requirement of Article III. See Maj. Op. at 10. For example, it is not argued that the case now before us is moot in the Article III sense.

Nor does it appear that this doctrine is rooted in non-Article III mootness decisions "reflecting avowedly flexible doctrines of remedy and judicial administration." 13A Charles Alan Wright, Arthur R. Miller, and Edward H. Cooper, *Federal Practice and Procedure* _3533.1 at 222 (1984). These doctrines are said to focus on the question whether "granting a present determination of the issues offered, and perhaps the entry of more specific orders, will have some effect in the real world." _Id._ at _3533.1 at 226 (footnote omitted). Here, it is clear that a determination of the merits of the issues raised by the Trustees and the entry of a remedial order on the basis of such a determination would have "some effect" -- and potentially quite a substantial effect -- in the real world. (That is precisely why Continental does not want us to entertain the appeal!)

Thus, as this case well illustrates, the doctrine of "equitable mootness" is not really about "mootness" at all in either the Article III or non-Article III sense. As the Seventh Circuit stated in a passage that the majority quotes with approval (see Maj. Op. at 12), "[t]here is a big difference between inability to alter the outcome (real mootness) and unwillingness to alter the outcome ('equitable mootness'). Using one word for two different concepts breeds confusion." _In re UNR Indus., Inc._, 20 F.3d 766, 769 (7th Cir.) (emphasis in original), cert. denied, 115 S. Ct. 509 (1994).

If the doctrine of "equitable mootness" is not based on real mootness principles, on what is it based? The cases cited by the majority and the parties suggest two possible answers.

The first is provided by the earliest court of appeals decision cited by the majority, _In re Roberts Farma, Inc._, 652 F.2d 793, 796-97 (9th Cir. 1981), and several others. See _In re AOV Industries, Inc._, 792 F.2d 1140, 1147 (D.C. Cir. 1986); _In re Information Dialogues, Inc._, 662 F.2d 475, 477 (8th Cir. 1981). The modest authority on which the Roberts Farma court relied was a provision of former Bankruptcy Rule 805, which concerned stays pending appeal. Added by a 1976 amendment to the rule, the provision in question stated:

> Unless an order approving a sale of property or issuance of a certificate of indebtedness is stayed pending appeal, the sale to a good faith purchaser or the issuance of a certificate to a good faith holder shall not be affected by the reversal or modification of such order on appeal, whether or not the purchaser or holder knows of the pendency of the appeal.
Although I do not find the Roberts Farms opinion entirely clear, I think that the best reading of the opinion is that the challenge to the plan of reorganization in that case could not be entertained because no relief was practicable as a result of the many post-confirmation transactions that were irreversible due to this provision of former Rule 805. See 652 F.2d at 797. In any event, whether or not this is what the Roberts Farms court meant to say, I do not see how any broader rule could reasonably be extracted from the provision of former Bankruptcy Rule 805 on which the Roberts Farms court relied or from the analogous provisions now contained in 11 U.S.C. § 363(m) and 364(e). If one begins with narrow provisions such as these -- which merely prevent the upsetting of certain specific transactions if stays are not obtained -- I do not see how one can derive the broad doctrine of "equitable mootness" that the majority in this case appears to embrace.

What apparently happened, however, was that the holding of Roberts Farms was gradually extended well beyond anything that could be supported by the authority on which Roberts Farms rested. Subsequent cases first cited Roberts Farms in support of the proposition that a bankruptcy appeal cannot be entertained if the court could not grant "effective relief." See, e.g., In re Information Dialogues, Inc., 662 F.2d at 477. Later, Roberts Farms was interpreted more expansively to mean that an appeal could not be entertained if a court could not award relief that was "equitable." See In re Chateaugay Corp., 988 F.2d 322, 324 (2d Cir. 1993) (citing Roberts Farms). And this latter holding figures prominently in the majority's analysis. See Maj. Op. at 12. In my view, this gradual but ultimately quite substantial extension of Roberts Farms cannot be squared with the narrow authority on which that decision relied. Accordingly, if anything like the majority's decision in this case is to be defended, some other foundation for the doctrine of "equitable mootness" must be found.

The second possible basis for the doctrine of "equitable mootness" is suggested in In re UNR Indus., supra, where the Seventh Circuit wrote:

Several provisions of the Bankruptcy Code of 1978 provide that courts should keep their hands off consummated transactions. For example, 11 U.S.C. § 363(m) says that the reversal of an order authorizing the sale or lease of property of an estate "does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal." Unless the sale is stayed pending appeal, the transaction survives even if it should not have been authorized in the first place. See In re Sax, 796 F.2d 994 (7th Cir. 1986); cf. In re Edwards, 962 F.2d 641 (7th Cir. 1992) (concluding that 363(m) does not, however, forbid all forms of collateral attack). Another section of the Code, 11 U.S.C. § 1127(b), dramatically curtails the power of a bankruptcy court to modify a plan of reorganization after its confirmation and "substantial consummation." Section 1127(b), unlike 363(m), does not place any limit on the power of the court of appeals, but the reasons underlying 363(m) and 1127(b) --preserving interests bought and paid for in reliance on judicial decisions, and avoiding the pains that attend any effort -- to unscramble an egg -- are so plain and so
compelling that courts fill the interstices of the Code with the same approach.

20 F.3d at 769.

Thus, the court seemed to say that the Bankruptcy Code contains an "interstice" -- a gap -- regarding the circumstances under which an appeal that might upset a plan of reorganization may be pursued. Further, the court appeared to suggest that the federal courts have the authority to create a rule of federal common law to fill this gap. See, e.g., United States v. Little Lake Misere Land Co., Inc., 412 U.S. 580, 593 (1973) (referring to the "`power in the federal courts to declare, as a matter of common law or judicial legislation," rules which may be necessary to fill in interstitially or otherwise effectuate the statutory patterns enacted in the large by Congress") (citation omitted).

This is an interesting theory, but I find it unnecessary to decide in this case whether it is correct. For present purposes, what is important is to note that, even if this theory is correct, it has nothing to do with mootness. Instead, it concerns a federal common law rule designed to promote certain policies of chapter 11 of the Bankruptcy Code. These policies are the facilitation of reorganizations and the protection of those who reasonably rely on reorganization plans. As I explain below, neither of these policies justifies what has happened in this case -- the refusal of the Article III courts to entertain a live appeal over which they indisputably possess statutory jurisdiction and in which meaningful relief can be awarded.

II.

A. How can the objective of preserving the Continental reorganization justify what the majority has done? The Trustees are not seeking to upset the plan of reorganization; rather, they are attempting to obtain payments that they claim are due to them pursuant to that plan. Moreover, even if the success of the reorganization might be imperilled if the Trustees obtained the full relief that they are seeking -- an empirical proposition that is not self-evident -- the courts could surely fashion some measure of lesser relief that would not disturb the reorganization. In order to justify its decision, which slams the courthouse door on the Trustees before they are even heard on the merits, the majority would have to show that the Trustees could not be awarded any relief -- not one dollar -- without upsetting the Continental reorganization, and obviously they cannot do any such thing. I do not dispute the desirability of preserving the Continental reorganization, but to my mind this objective implicates a question of remedy, to be decided after the merits of the Trustees' arguments are addressed, and not a threshold question of "mootness."

In treating this as a threshold question, the majority, I believe, has been confused by the misleading term "equitable mootness," which, as I have discussed, does not actually involve mootness at all. The federal courts are accustomed to considering questions of Article III mootness, and the majority, in my view, has fallen into the trap of thinking that the question of "equitable mootness" that is now before us must be treated as if it were a question of Article III mootness. Whether a case is moot in the Article III sense is, of course, a jurisdictional question, see, e.g., Rosetti v. Shalala, 12 F.3d 1216, 1223 (3d Cir. 1993), and therefore it is a question that we are obligated to resolve before we consider the merits of an appeal.
See, e.g., United Wire Metal and Machine Health and Welfare Fund v. Morristown Memorial Hosp., 995 F.2d 1179, 1190 (3d Cir.), cert. denied, 114 S. Ct. 382 (1993); Rogin v. Bensalem Tp., 616 F.2d 680, 684 (3d Cir. 1980), cert. denied, 450 U.S. 1029 (1981). Moreover, if we conclude that an appeal is moot in this sense, we have little remedial flexibility; we generally have no choice but to dismiss. See, e.g., U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership, 115 S. Ct. 386, 389-90 (1994); Mills v. Green, 159 U.S. 651, 653 (1895) (when "an event occurs which renders it impossible for this court, if it should decide the case in favor of the plaintiff, to grant him any effectual relief whatever, the court will not proceed to a formal judgment, but will dismiss the appeal").

By contrast, the doctrine that is involved here -- which is not really a doctrine of mootness at all -- does not demand or justify similar treatment. It does not present a jurisdictional question; we are not required to consider it before proceeding to the merits; and even if we find that it is applicable, it does not necessarily dictate that we dismiss the appeal or affirm in its entirety a district court order of dismissal. Rather, we retain the ability to craft, or to instruct the district or bankruptcy courts to craft, a remedy that is suited to the particular circumstances of the case. Thus, a remedy could be fashioned in the present case to ensure that the Continental reorganization is not undermined.

B. Much the same is true with respect to the objective of protecting reasonable reliance interests. In my opinion, this is also a remedial consideration; if the Trustees win on the merits, the need to protect reasonable reliance interests can be fully taken into account in crafting an appropriate remedy. I thus see no need to resolve the question of reasonable reliance interests at this time.

The majority, however, not only wrongly treats this as a threshold, rather than a remedial, consideration, but engages in an analysis that flies in the face of the language of the plan and seems to assume an extraordinary degree of naivete on the part of the Investors and the others who are said to have relied on the plan.

I will focus on the Investors because their plight looms large in the majority's analysis. When the Investors decided to invest in the reorganized company, NewCal, they knew or should have known that under the reorganization plan NewCal would be required to pay the Trustees' claim if it was ultimately allowed. Section 10.1 of the plan provided that NewCal would pay "Allowed Administrative Claims." Moreover, in order to persuade the bankruptcy court to reject the Trustees' request that a cash reserve be established prior to confirmation to cover their claim, Continental argued that such a reserve was unnecessary because if the Trustees' claim was allowed it would be "an Allowed Administrative Claim which would be paid in accordance with the terms of Section 10.1 of the Plan." JA 1039. Under these circumstances, any prudent investor, in deciding whether to invest in NewCal on particular terms, would have taken into account the range and likelihood of possible outcomes in the Trustees' appeal, including the possibility that some or all of the amount sought by the Trustees would have to be paid as an administrative claim pursuant to Section 10.1 of the plan. No reasonable investor would have proceeded on the assumption that the Trustees would definitely recover nothing. And the same is true of the other parties that relied on the plan. Thus, I am skeptical about the reliance interests that are claimed here, but in any event I fail to see why this issue needs to be resolved at the

Appendix 21(a) - Continental en banc Decision

Chapter 11-101
C. One final aspect of the majority opinion warrants a response, and that is the majority's discussion of the Trustees' failure to seek or obtain a stay. I have two comments regarding this discussion.

First, while it might be desirable to have a rule that flatly requires a stay whenever a party takes an appeal that might upset a plan of reorganization, neither the Bankruptcy Code nor the Bankruptcy Rules contain any such sweeping provision; our court had not adopted any such rule at the time of the Trustees' appeal (and, indeed, still has not done so); and it would consequently be unfair to apply such a rule to the Trustees retroactively.

Second, in the absence of such a blanket rule, we should focus on whether the purposes that would be served by a stay require that the Trustees be thrown out of court at the threshold. The purpose of a stay in this context is to prevent transactions that might otherwise occur in reliance on the plan of reorganization and that would be difficult or painful to undo if the appeal were to succeed. Accordingly, the Trustees' failure to obtain a stay in this case might limit the relief that would be available to them if they succeeded on the merits of their appeal, but it cannot justify the refusal at the outset even to consider their arguments.

In sum, I believe that the Trustees' claim should be entertained on the merits. The mere act of entertaining that claim would not imperil Continental's reorganization or impair any legitimate reliance interests. If the Trustees' claim were considered and they won on the merits, any threat to the reorganization or to legitimate reliance interests could be taken into account in framing the Trustees' relief. What the district court and the majority have done -- throwing the Trustees out of court before the merits of their claim are even heard -- is unjustified and unjust.

For these reasons, I respectfully dissent. I would reverse the order of the district court and remand for a decision on the merits.
Planet Earth is getting smaller and smaller. Technological innovations make distance irrelevant in many ways and international treaties and unions make nationalities increasingly meaningless in many ways. As a result, insolvencies of a non-U.S. business impact U.S. businesses every day, and U.S. bankruptcies likewise impact non-U.S. business everyday. Moreover, there are a huge number of businesses with operations in multiple countries. The BAPCPA added chapter 15 to the Bankruptcy Code to address the subject of cross-border insolvencies.

Chapter 15 is based upon a model law proposed by the United Nations Commission on International Trade Law (UNCITRAL). UNCITRAL has performed extensive work in international commercial law, resulting in widely used international conventions and model laws. The Model on Cross-Border Insolvency is the basis for chapter 15, which replaces former Code §304.

The goal of chapter 15 is to increase international cooperation in cross-border cases by enabling bankruptcy courts in the United States to recognize foreign insolvency proceedings. These insolvency proceedings are of two types. An insolvency proceeding that is pending where the debtor has its “center of its main interests” is defined as a “foreign main proceeding.” See §1502(4), while other insolvency proceedings in countries in which the debtor is carrying on “nontransitory economic activity” are defined as “foreign nonmain proceedings.” See §1502(5).

Commencement of Chapter 15 Case

A chapter 15 case of either type is commenced by the filing of a petition for recognition of a foreign proceeding under §1515. Upon recognition of a foreign proceeding, §§361, 362, 365, 349 and 352 automatically apply with respect to the debtor, the property of the debtor, and transfers of interests of the debtor in property within the territorial jurisdiction of the United States, and a foreign representative may operate the debtor’s business and exercise the rights and powers of a trustee under §§363 and 552. See §1520. The court may also grant additional stays to protect the debtor’s assets, obligations, and liabilities in the United States beyond the scope of those basic provisions of the Bankruptcy Code. See §1521.

Administrative Issues

Additional actions may be undertaken by the foreign representatives under §§522, 544, 545, 547, 548, 550, 553 and 724(a). See §1523. However, those powers to commence such actions to avoid acts detrimental to creditors are limited where the foreign proceeding is “nonmain” in nature. See §1523.

Chapter 15 contains several provisions to facilitate cooperation and communication between the United States bankruptcy courts and trustees with the foreign courts and representatives. See §§1525-30. For example, the courts may communicate directly with each
other, under §1525 (b), “by any means considered appropriate by the court.” See 11 U.S.C.A. §1527(2).
APPENDIX 22(a)

PETITION OF LLOYD
ORDER GRANTING RECOGNITION AND RELIEF
IN AID OF FOREIGN MAIN PROCEEDING
PURSUANT TO 11 U.S.C. §§ 1517, 1520, 1521

A hearing having been held before the Court on December 7, 2005 (the
"Hearing") to consider the Chapter 15 Petition for recognition and relief, including
injunctive relief, in aid of a foreign proceeding, filed November 11, 2005, pursuant to
11 U.S.C. §§ 1504 and 1515, by Jeffrey John Lloyd, as foreign representative (the
"Petitioner") of the United Kingdom proceeding concerning the solvent scheme of
arrangement sanctioned October 28, 2005, by the High Court of Justice of England and
Wales (the "UK, High Court") respecting that certain marine insurance Account known as
the MMA Account, the debtor in the foreign proceeding, written by Les Mutuelles du
Mans Assurances IARD, the United Kingdom Branch of La Mutuelle du Mans
Assurances IARD, f/k/a Les Mutuelles du Mans IARD, f/k/a La Mutuelle Générale
Française Accidents, (the "MMA"); and due and timely notice of the filing of the Chapter
15 Petition and the Hearing thereon having been given by the Petitioner by publication in
relevant domestic and international publications and by direct notice by mail made by the
Petitioner individually to all known parties in interest, wherever located, which notice was adequate for all purposes such that no other or further notice thereof need be given; and the Court having considered and reviewed all other pleadings and exhibits submitted by the Petitioner in support of the Chapter 15 Petition; and no objections or other responses having been filed thereto; and all interested parties having had due and proper notice and an opportunity to be heard; and the Court having heard arguments by counsel appearing at the Hearing; and after due deliberation and sufficient cause appearing therefore, the Court finds and concludes as follows:


2. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(P).

3. Venue is properly located in this District pursuant to 28 U.S.C. § 1410.

4. The Petitioner is a person pursuant to 11 U.S.C. § 101(41) and is the duly appointed foreign representative of the debtor pursuant to 11 U.S.C. § 101(24).

5. The Chapter 15 case properly was commenced pursuant to 11 U.S.C. §§ 1504 and 1515.


7. The proceeding for adoption, sanction and implementation of the solvent scheme of arrangement respecting the debtor pursuant to Section 425 of the Companies Act of 1985 of Great Britain under the jurisdiction and supervision of the UK High Court.
for the adjustment and liquidation of the claims of Scheme Creditors\(^1\) is a foreign proceeding pursuant to 11 U.S.C. § 101(23) (the "Foreign Proceeding").

8. The Foreign Proceeding is entitled to recognition by this Court pursuant to 11 U.S.C. § 1517.

9. The Foreign Proceeding is pending in the country where the center of main interests of the debtor is located and, as such, is a foreign main proceeding pursuant to 11 U.S.C. § 1502(4) entitled to recognition as a foreign main proceeding pursuant to 11 U.S.C. § 1517(b)(1).

10. The Petitioner is entitled to all relief provided pursuant to 11 U.S.C. § 1520 without limitation.

11. The Petitioner further is entitled to the relief expressly set forth in 11 U.S.C. §§ 1521(a) and (b) and as granted hereby.

12. The relief granted hereby, including permanent injunctive relief, is necessary and appropriate, in the interests of the public and international comity, consistent with the public policy of the United States, warranted pursuant to 11 U.S.C. § 1521 and Federal Rule of Bankruptcy Procedure 7065, and will not cause any hardship to Scheme Creditors or other parties in interest that is not outweighed by the benefits of granting that relief.

13. Unless an injunction is issued, one or more parties may interfere with, or otherwise cause harm to, the administration, implementation and enforcement of the scheme of arrangement, including the satisfaction of the claims of Scheme Creditors, causing immediate and irreparable harm to the detriment of Scheme Creditors and other

\(^1\) Capitalized terms not otherwise defined herein have the meaning ascribed to them in the Verified Petition filed November 11, 2005 contemporaneously with and in further support for the Chapter 15 Petition.
parties in interest in the Foreign Proceeding for which there will be no adequate remedy at law, including, *inter alia*, by: (i) commencing or continuing the prosecution of judicial, arbitral, administrative or regulatory actions or proceedings involving property, or the proceeds thereof, of, without limitation, MMA located in the territorial jurisdiction of the United States that may be used to satisfy claims in the Foreign Proceeding; (ii) seeking to enforce judicial, quasi-judicial, arbitral, administrative or regulatory actions, assessments, orders or any arbitration awards, and/or commence or continue actions or other legal proceedings to create, perfect, or enforce liens, set-offs, or other claims against such property or proceeds; and (iii) otherwise seeking to obtain, or seeking to retain, custody, possession or control over assets contemplated by the Foreign Proceeding to be available for the implementation of the scheme of arrangement.

NOW, THEREFORE, IT IS HEREBY:

ORDERED that the Foreign Proceeding is granted recognition pursuant to 11 U.S.C. § 1517(a); and it is further

ORDERED that the Foreign Proceeding is granted recognition as a foreign main proceeding pursuant to 11 U.S.C. § 1517(b)(1).

ORDERED that the scheme of arrangement sanctioned by the UK High Court in the Foreign Proceeding shall be given full force and effect and be binding on and enforceable in the United States against all persons and entities; and it is further

ORDERED that all persons and entities are hereby permanently enjoined and restrained from taking any actions or steps in the United States inconsistent with, or to the detriment of, the Foreign Proceeding or the scheme of arrangement or its administration, implementation or enforcement, including, *inter alia*, as set forth herein; and it is further
ORDERED that all persons and entities, other than in accordance with the Foreign Proceeding and the scheme of arrangement, are permanently enjoined from commencing or continuing any action or other legal proceeding (including, without limitation, arbitration, or any judicial or quasi-judicial, administrative or regulatory action, proceeding or process whatsoever) or any other proceeding in the United States, in respect of a Scheme Claim or other subject of the Foreign Proceeding or scheme of arrangement, against the debtor, the Petitioner, the Scheme Advisers, the Scheme Adjudicator, any estate created by the Foreign Proceeding or scheme of arrangement, or MMA or its property or the proceeds thereof contemplated by the Foreign Proceeding or scheme of arrangement to be available for the administration, implementation or enforcement of the scheme of arrangement; and it is further

ORDERED that all persons and entities, other than in accordance with the Foreign Proceeding and the scheme of arrangement, are permanently enjoined from enforcing any judicial, quasi-judicial, administrative or regulatory action, assessment, order or any arbitration award, and commencing or continuing any act or any action or other legal proceeding (including, without limitation, arbitration, or any judicial, quasi-judicial, administrative or regulatory action, proceeding or process whatsoever), to create, perfect, or enforce any lien, set-off, or other claim, in respect of a Scheme Claim or other subject of the Foreign Proceeding or scheme of arrangement, against the debtor, the Petitioner, the Scheme Advisers, the Scheme Adjudicator, any estate created by the Foreign Proceeding or scheme of arrangement, or MMA or its property or the proceeds thereof contemplated by the Foreign Proceeding or scheme of arrangement to be
available for the implementation, administration or enforcement of the scheme of arrangement; and it is further

ORDERED that all persons and entities, other than in accordance with the Foreign Proceeding and the scheme of arrangement, are permanently enjoined from transferring, encumbering or otherwise disposing of any assets of the debtor, any estate created by the Foreign Proceeding or scheme of arrangement, or of MMA contemplated by the Foreign Proceeding or the scheme of arrangement to be available for the implementation, administration or enforcement of the scheme of arrangement; and it is further

ORDERED that, except as prohibited by 11 U.S.C. § 1501(d) respecting deposits, escrows, trust funds, or other security required or permitted under any applicable State insurance law or regulation for the benefit of claim holders in the United States, all persons or entities, other than in accordance with the Foreign Proceeding and the scheme of arrangement, are permanently enjoined from invoking, enforcing or relying on the benefit of any statute, rule or requirement of federal, state or local law or regulation requiring the debtor, the Petitioner, the Scheme Advisers, the Scheme Adjudicator, any estate created by the Foreign Proceeding or scheme of arrangement, or MMA to establish or post security in the form of a bond, letter of credit or otherwise as a condition of prosecuting, defending or appealing any action or other legal proceeding (including, without limitation, arbitration or any judicial, quasi-judicial, administrative or regulatory action, proceeding or process whatsoever) in respect of a Scheme Claim or other subject of the Foreign Proceeding or scheme of arrangement, and the application of such statute, rule or requirement will be rendered null and void for such actions and proceedings;
provided, however, that nothing herein shall in any respect affect any existing security or
the replacement of such security; and it is further

ORDERED that, except as prohibited by 11 U.S.C. § 1501(d) respecting deposits,
escrows, trust funds, or other security required or permitted under any applicable State
insurance law or regulation for the benefit of claim holders in the United States, all
persons and entities, other than in accordance with the Foreign Proceeding and the
scheme of arrangement, are permanently enjoined from drawing down on any letter of
creditor in excess of amounts expressly authorized pursuant to such letter of credit
established by, on behalf of, or at the request of, the debtor, the Petitioner, the Scheme
Advisers, the Scheme Adjudicator, any estate created by the Foreign Proceeding or
scheme of arrangement, or MMA, in respect of a Scheme Claim or other subject of the
Foreign Proceeding or scheme of arrangement, or withdrawing from, setting off against,
or otherwise applying property that is the subject of any trust or escrow agreement or
similar arrangement in which the debtor, the Petitioner, the Scheme Advisers, the Scheme
Adjudicator, any estate created by the Foreign Proceeding or scheme of arrangement, or
MMA has an interest, in excess of amounts expressly authorized by the terms of the
contract and any related trust or other agreement pursuant to which such letter of credit,
trust escrow, or similar arrangement has been established, and it is further

ORDERED that all persons and entities given notice of the Petition and the
Hearing thereon in possession, custody or control of property, or the proceeds thereof,
located within the territorial jurisdiction of the United States, of the debtor, any estate
created by the Foreign Proceeding or the scheme of arrangement, or of MMA
contemplated by the Foreign Proceeding to be available for the implementation of the
scheme of arrangement, shall forthwith so advise the Petitioner by written notice sent to the Scheme Advisers at the following address: The Scottish Lion Underwriting Agencies Limited, ATTN: Jeffrey John Lloyd and Stephen Crawley, 5th Floor, Cutlers Exchange, 123 Houndsditch, London EC3A 7PQ, United Kingdom, or to such other address as notified as provided in the scheme of arrangement, which written notice respecting custody, possession or control of property or proceeds shall set forth: (i) the nature of such property or proceeds; (ii) when and how such property or proceeds came into the custody, possession or control of such person or entity; and (iii) the full identity and contact details of such person or entity including, without limitation, the name, title, affiliation, full street address, telephone number, facsimile number and any e-mail address and website for such person or entity; and it is further

ORDERED that, whether or not a person or entity in such custody, possession or control of the property as set forth above so advises the Petitioner as required herein, all persons or entities in such custody, possession or control of the property, upon notice and demand by the Petitioner or the Scheme Advisers acting for the Petitioner, are required to, and shall forthwith, turn over and account for such property or proceeds to the Petitioner, or to the Scheme Advisers acting for the Petitioner, for administration and distribution in the Foreign Proceeding in the United Kingdom in accordance with the scheme of arrangement, and it is further

ORDERED that nothing in this Order shall in any respect prevent the continuation or commencement of proceedings against or involving any person or entity other than the debtor, the Petitioner, the Scheme Advisers, the Scheme Adjudicator, any estate created by the Foreign Proceeding or scheme of arrangement, or MMA in respect of a
Scheme Claim or other subject of the Foreign Proceeding or scheme of arrangement; provided, however, that if any third party shall reach a settlement with, or obtain a judgment against, any person or entity other than the debtor, the Petitioner, the Scheme Advisers, the Scheme Adjudicator, any estate created by the Foreign Proceeding or scheme of arrangement, or MMA, in respect of a Scheme Claim or other subject of the Foreign Proceeding or scheme of arrangement, such settlement or judgment shall not be binding on or enforceable against the debtor, the Petitioner, the Scheme Advisers, the Scheme Adjudicator, any estate created by the Foreign Proceeding or scheme of arrangement, or MMA or its property, or the proceeds of such property, contemplated by the Foreign Proceeding or scheme of arrangement to be available for the implementation, administration or enforcement of the scheme of arrangement; and it is further

ORDERED that, pursuant to Rule 7065 of the Federal Rules of Bankruptcy Procedure, the security provisions of Rule 65(c) of the Federal Rules of Civil Procedure shall be, and the same hereby are, waived; and it is further

ORDERED that the Petitioner is authorized to as appropriate examine witnesses, take evidence or seek the delivery of information concerning the assets, affairs, rights, obligations or liabilities of the debtor or MMA in respect or for the benefit of the debtor, the Foreign Proceeding or the scheme of arrangement; and it is further

ORDERED that the Petitioner and, at his direction, any or all of the Scheme Advisers and Scheme Adjudicator, are authorized to operate the business that is the subject of the Foreign Proceeding and the scheme of arrangement, and the Petitioner may exercise the powers of a trustee under and to the extent provided by 11 U.S.C. §§ 363 and 552; and it is further
ORDERED that, as all identifiable parties in interest wherever located as listed in Appendix VIII to the Official Form Chapter 15 Petition filed November 11, 2005 (the “Notice Parties”) have within the Foreign Proceeding been served notice of the procedures, requirements and deadlines for asserting claims under the scheme of arrangement as well as a Claim Form, and as the Notice of Filing and Hearing on the Chapter 15 Petition served on such parties in this case further informs them of the notices and Claim Form provided in the Foreign Proceeding and specifies the website through which such notices and Claim Form might be obtained, that the requirements contained in 11 U.S.C. § 1514(c) hereby are deemed to have been fulfilled; and it is further

ORDERED that this Court shall retain jurisdiction with respect to the enforcement, amendment or modification of this Order, any requests for additional relief or any adversary proceeding brought in and through this Chapter 15 Case, and any request by an entity for relief from the provisions of this Order for cause shown properly commenced and within the jurisdiction of the United States Bankruptcy Court; and it is further

ORDERED that the UK High Court shall have and retain exclusive jurisdiction to hear and determine any suit, action, claim or proceeding, and to settle any dispute that may arise out of the construction or interpretation of, or pursuant to, the scheme of arrangement; provided, however, that nothing in this Order shall affect the validity of contractual provisions determining governing law and jurisdiction not otherwise determined by the scheme of arrangement or the Foreign Proceeding; and it is further

ORDERED that no action taken by the Petitioner, the Scheme Advisers, the Scheme Adjudicator, MMA, or each of their successors, agents, representatives, advisers
or counsel, in preparing, disseminating, applying for, implementing or otherwise acting in furtherance of or in connection with the Foreign Proceeding, the scheme of arrangement, this Order, or this Chapter 15 case, or any adversary proceeding herein, or further proceeding commenced hereunder, shall be deemed to constitute a waiver of the immunity afforded to such persons under 11 U.S.C. §§ 306 and 1510; and it is further

ORDERED that a true and correct copy of this Order shall be served:

(a) by United States mail, first class postage prepaid, on or before December 22, 2005, upon all Notice Parties; and

(b) by a single publication of notice of entry of this Order in each of The Wall Street Journal (US Edition) and Business Insurance magazine on or before December 22, 2005;

and it is further

ORDERED, that such service shall be good and sufficient service and adequate notice for all purposes.

Dated: New York, New York
December 7, 2005
@ 11:00 a.m.

/s/Burton R. Lifland
United States Bankruptcy Judge
Chapter 23
Bibliography:
Cases You Should Know So You Don’t Have to Pretend

Jurisdiction

FCC v. NextWave Personal Communications, Inc., 200 F.3d 43 (2d Cir. 1999). The Second Circuit held the FCC has exclusive jurisdiction regarding allocation of radio spectrum licenses. In addition bankruptcy and district courts lack jurisdiction to employ remedies that abrogate FCC licensing authority.

Singleton v. Fifth Third Bank, 230 B.R. 533 (B.A.P. 6th Cir. 1999). The Sixth Circuit held that the Rooker-Feldman doctrine prevents a bankruptcy court from acting in an appellate capacity on a matter decided in state court. There is an exception to this doctrine when the state judgment at issue was obtained through “fraud, deception, accident, or mistake.” Id. at 538 (citations omitted) However, absent the exception, the doctrine is non-waivable and must be applied to actions which are “inextricably intertwined with the state-court judgment.” Id. at 536.

A.H. Robins Co. v. Piccininn, 788 F.2d 994 (4th Cir. 1986). The court held that the District Court has the authority to fix venue to its district and to transfer all related cases to its court for disposition. In order for a debtor to reorganize, all claims have to be centralized.

In re Castlerock Properties, 781 F.2d 159 (9th Cir. 1986). The Ninth Circuit held that even if a state law contract claim does not fall specifically within the categories of core proceedings stated in 28 U.S.C. §157(b)(2)(B)–(N) it is nevertheless a related proceeding under 29 U.S.C. §157(c). This is so even if the contract claim would arguably fit within the literal meaning of the two-catch-all provisions, 28 U.S.C. §157(b)(2)(A) and (O). Furthermore, filing an affirmative defense is not consent to jurisdiction, but filing a proof of claim in the bankruptcy court is consent to jurisdiction.

In re Pacor Inc. v. Higgins, 743 F.2d 984 (3d Cir. 1984). The most widely-accepted test for “related-to” jurisdiction was articulated in Pacor as follows: “An action is related to bankruptcy if the outcome could alter the debtor’s rights, liabilities, options, or freedom of action (either positively or negatively), and which in any way impacts upon the handling and administration of the bankrupt estate.” Id. at 994. The Supreme Court cited this test with approval in Celotex, 514 U.S. 300, 308 n.6 (1995).

Geyer v. Ingersoll Publications Co., 621 A.2d 784 (Del. Ch. 1992). Although courts are divided on the issue, most courts take the view that insolvency expands the fiduciary duties of directors and officers beyond shareholders to include creditors. However, there is disagreement when these duties arise. Geyer is frequently cited as the leading case espousing the view that duties arise at “the fact of insolvency.” Id. at 791. Other courts have found that duties arise when bankruptcy proceedings are instituted. The Geyer rule acts to shift the duties from shareholders to creditors at an earlier time.

Pre-petition Debts

In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004). Courts have been mixed on authorizing pre-confirmation payment of pre-petition debts owed to critical vendors, but not until Kmart did a Court of Appeals do any great violence to the doctrine. The Seventh Circuit found no statutory support for the bankruptcy judge’s critical vendors order. The Court did not bar all future critical vendor orders; to meet the burden of proof to pay critical vendors first, debtors need to show that the vendors “would have ceased doing business with [them] if not paid for pre-petition deliveries” and that “discrimination among unsecured creditors was the only way to facilitate a reorganization.” Id. at 874.

Federal Communications Comm’n v. NextWave Personal Communications, 537 U.S. 293 (2003) Section 525(a) of the Bankruptcy Code provides, subject to explicit exemptions, that a governmental unit may not revoke a license to a person that is a debtor under Title 11 solely because such debtor has not paid a debt that is dischargeable under Title 11. After the debtor’s failure to make payments for blocks of spectrum licenses, the FCC cancelled the licenses pursuant to the terms of the auction, which provided that failure to make payments would result in automatic cancellation. The Court held that the FCC was a governmental unit revoking a license under §525(a), debtor’s license obligations to the FCC were debts dischargeable under Title 11, §525(a) did not conflict with the FCC’s licensing authority and that the Court of Appeals properly prevented the FCC from violating §525(a) of the Bankruptcy Code by prohibiting the FCC from revoking the licenses in question upon the debtor’s failure to make timely payments owed to the FCC.

Grady v. A.H. Robins Co., 839 F.2d 198 (4th Cir. 1988). In bankruptcy, accrual of claims is determined by bankruptcy law, not state law. For purposes of a tort “claim” in bankruptcy, the claim arises when the acts constituting the tort or breach of warranty occurred. Only claims arising pre-petition are stayed under §362.

Dismissal of Bad Faith Filings

In re Victory Construction Co., 9 B.R. 549 (Bankr. C.D. Cal. 1981), vacated on other grounds, 37 B.R. 222 (B.A.P. 9th Cir. 1984). While the Bankruptcy Code does not explicitly require good faith for the filing of a voluntary petition, Victory is often referred to as the seminal case finding an implicit good faith requirement. The Third Circuit in SGL Carbon concluded that a chapter 11
petition is subject to dismissal unless it is filed in good faith. In Integrated Telecom Express, the Third Circuit dismissed a case filed by a solvent firm for the purpose of capping its debt on a long-term lease noting that the firm had no intention of reorganizing or liquidating and there was no reasonable expectation that the bankruptcy proceedings would maximize the value of the debtor’s estate for creditors. 384 F.3d 108 (3d Cir. 2004).

**Property of the Estate**

*United States v. Craft*, 535 U.S. 274 (2002). Husband’s interest in the entireties property constituted “property” or “rights to property” to which a federal tax lien may attach.


*In re LTV Steel Co., Inc.*, 274 B.R. 278 (Bankr. N.D. Ohio 2001). The court held that the debtor’s receivables and inventory previously transferred as part of an asset-backed securities transaction were available to the estate as part of a cash collateral order. The issue was appealed but the parties settled prior to review. While the court’s ruling was not a final decision on whether the transaction was a “true sale,” it created a good deal of concern in the securitization industry and Congress has failed in its attempts to amend Bankruptcy Code §541 to exclude asset-backed securitizations.

*Octagon Gas Sys. v. Rimmer*, 995 F.2d 948 (10th Cir. 1993), cert. denied, 510 U.S. 993 (1993). The Tenth Circuit held that an account that had been sold still remained part of the seller’s property and therefore became part of the seller’s bankruptcy estate. The court stated that Article 9 treats the buyer of an account as secured creditor, the seller as debtor, and the accounts sold as collateral. *Octagon Gas* was heavily criticized and revised Article 9 clarifies that a seller of accounts retains no interest in the property sold.

*United States v. Whiting Pools, Inc.*, 462 U.S. 198 (1983). The Supreme Court held that the bankruptcy estate included a debtor’s property that had been seized by the IRS prior to the filing of the case. While the Court noted that Bankruptcy Code §§542(a), 363, and 541(1)(a) could be read as limiting the estate to “interests of the debtor in property” at the time of the filing, the Court chose to “view them as a definition of what is included in the estate rather than as a limitation.” *Id.* at 202-03. *Whiting Pools* highlights the dual meaning of the word “property” as used in §§541 and 542 of the Code: the debtor’s intangible “interest” in a particular thing in the former, and the tangible “thing” in the latter.

*Butner v. United States*, 440 U.S. 48 (1979). Resolving a conflict between the Third and Seventh Circuits on one side and the Second, Fourth, Sixth, Eighth, and Ninth Circuits on the other, the Supreme Court stated that the creation of property interests in bankruptcy are determined on the basis of state law.

**Automatic Stay**

*United States v. Consumer Health Servs.*, 108 F.3d 390 (D.C. Cir. 1997). The D.C. Circuit held that recoveries of Medicare overpayments relating to previous cost years constitute the same
transaction and thus collection by recoupment is not barred by the automatic stay. The Third Circuit in an earlier case, found that the this method of collection of Medicare overpayments was a setoff rather than a recoupment and thus, collection was barred by the automatic stay. The First Circuit and the Ninth Circuit have followed the D.C. Circuit’s analysis. These cases are also significant for the analysis they provide on the oft-confused distinction between setoff and recoupment.

_Citizens Bank v. Strumpf_, 516 U.S. 16 (1995). The Supreme Court held that a person who owes money to a debtor may temporarily refuse to make payment to the debtor in order to preserve its right to a setoff without violating the automatic stay. A previous case in the Third Circuit had held that a creditor’s withholding of funds subject to a setoff violated the automatic stay and setoff is not permitted after confirmation of the plan. _Norton_, 717 F.2d 767 (3d Cir. 1983). The Third Circuit subsequently determined that _Norton_ survives _Strumpf_, distinguishing it, based on that it dealt with a bank’s pre-confirmation temporary withholding. _Continental Airlines_, 134 F.3d 536 (3d Cir. 1998), _cert. denied_, 525 U.S. 929 (1998).

_Board of Governors of Federal Reserve System of United States v. MCorp Financial, Inc._, 502 U.S. 32 (1991). Court held that Bankruptcy Code §362(b)(4) precludes courts from enjoining a governmental unit from practicing its policing or regulating power. This power is not dependent upon a court ruling of the legitimacy of the governmental unit’s actions.

_In re Twist Cap, Inc._, 1 B.R. 284 (Bankr. M.D. Fla. 1979). Decided under the Bankruptcy Act, the court issued a preliminary injunction to prevent unsecured creditors from drawing on a debtor’s letter of credit that was issued by a bank having a secured claim for reimbursement from the debtor. The court reasoned that if the letters of credit were honored by the bank, the bank would assert that the properties of the debtor included in the collateral previously pledged secure all indebtedness of the debtor owed to the bank, including amounts paid out by the bank by virtue of its honoring the letters of credit. The court essentially acted to preserve the status quo and prevent potential deterioration of the bankruptcy estate. This decision has been criticized and otherwise rejected or ignored by courts and commentators. Even the judge in Twist Cap later retreated from his holding.

**Secured Claims**

_Hartford Underwriters Inc. Co. v. Union Planters Bank, N.A._, 530 U.S. 1 (2000) (a/k/a the “Henhouse” case). In resolving a split among the circuit courts, the Supreme Court held that Bankruptcy Code §506(c) authorizes only the trustee (or debtor-in-possession) to recover from a secured creditor’s collateral the reasonable costs and expenses of preserving or disposing of the collateral. In _Cybergenics_, the Third Circuit _en banc_ declined to extend the Supreme Court’s analysis to Bankruptcy Code §544(b) and it authorized a creditors’ committee to sue on the estate’s behalf to avoid a fraudulent transfer. 330 F.3d 548, 580 (2003).

_Fidelity Financial Services, Inc. v. Fink_, 522 U.S. 211 (1998). The trustee sought to set aside a creditor’s purchase money security interest as preferential. The creditor attempted to perfect its PMSI in the debtor’s vehicle by invoking the state law “enabling loan” exception to the trustee’s preference avoiding power. The Supreme Court held that the time within which a secured party
must perform the acts necessary to perfect its PMSI is governed by federal law, not state law. Thus, the state’s 20-day period for perfection under its “enabling loan” exception did not apply.

*Associates Comm’l Corp. v. Rash*, 520 U.S. 953 (1997). In a chapter 13 cramdown, the value of the property, and thus the amount of the secured claim under §506(a), is replacement value. Replacement value is the price a willing buyer in debtor’s trade, business or situation would pay to obtain like property from a willing seller.

*Rake v. Wade*, 508 U.S. 464 (1993). The Supreme Court granted certiorari to resolve a conflict between circuits as to whether “chapter 13 debtors who cure a default on an oversecured home mortgage pursuant to §1322(b)(5) of the Bankruptcy Code, 11 U.S.C. §1322(b)(5), must pay postpetition interest on the arrearages.” *Id.* at 465. The Supreme Court decided that the “holder of the mortgage is entitled to such interest under §§506(b) and 1325(a)(5) of the Code.” *Id.*


*Dewsnap v. Timm*, 502 U.S. 410 (1992). In this chapter 7 case, the Supreme Court held that §506(d) did not allow petitioner to “strip down” respondents’ lien to the judicially determined value of the collateral, because respondents’ claim was secured by a lien, and had been fully allowed pursuant to §502. Respondents’ lien, therefore, could not be classified as “not an allowed secured claim” for purposes of the lien-voiding provision of §506(d).

*United States v. Ron Pair Enterprises*, 489 U.S. 365 (1989). The Supreme Court held that Bankruptcy Code §506(b) entitles holders of all oversecured claims, including holders of nonconsensual liens, to post-petition interest. Holders of consensual security interests are also entitled to recover reasonable costs, fees, and charges to the extent their agreements with the debtor so provide.

*United Savings Association v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365 (1988). An undersecured creditor is not entitled to adequate protection payments to compensate it solely for the delay in its ability to foreclose on its collateral caused by the automatic stay. There is no recovery for the loss of the “value of money.” The Supreme Court also stated that an undersecured creditor is entitled to relief from the stay unless the debtor can show that the creditor’s collateral is necessary to a reorganization that is “in prospect.”

*Till v. SCS Credit Corp.*, 541 U.S. 465 (2004). The Supreme Court adopted the “formula approach” for determining the appropriate interest rate to be used to determine the present value of a stream of payments. Under this approach, the national prime rate is used as a starting point and is increased based upon the risk of default in the particular case. The Court rejected the “coerced loan,” “presumptive contract rate,” and “cost of funds” approaches for determining an interest rate. While *Till* involved payments to a secured creditor under a chapter 13 plan, the Court suggests that the same approach should be used in chapter 11 in many circumstances.
Equitable Power of the Bankruptcy Court

*In re Cajun Electric Power Cooperative, Inc.*, 185 F.3d 446 (5th Cir. 1999). The Fifth Circuit held that the issuance of an injunction preventing the Louisiana Public Service Commission from taking certain actions constituted an abuse of the bankruptcy court’s discretion. The bankruptcy court may only enjoin a governmental unit in exceptional circumstances, and those circumstances did not exist in this case. Enjoining the LPSC would prevent them from protecting public interests, which is what the state law gives them the discretion to do. Also, the LPSC was careful to make sure that their changes would not alter the bankruptcy court’s ultimate decision about whether the post-petition interest will be discharged.

*Pioneer Investment Services Co. v. Brunswick Assoc. Ltd. P’ship*, 507 U.S. 380 (1993). In resolving a circuit split on the issue, the Court held that Bankruptcy Rule 9006(b)(1), which allows a court to permit late filings where the failure to comply with the deadline “was the result of excusable neglect” by the movant, involves an equitable determination, including a review of: (i) the prejudice to the debtor, (ii) length of the delay and its impact on the case, (iii) the reason for the delay (including whether the delay was within the reasonable control of the movant) and (iv) the good faith of the movant. The Court also noted that it is proper to attribute to creditors the fault of their attorney.

*In re Augie/Restivo Baking Co.*, 860 F.2d 515 (2d Cir. 1988). The court held that while substantive consolidation is a product of judicial gloss, it is justified where the time and expense necessary to attempt to unscramble the debtors is so substantial as to threaten the realization of any assets for all creditors. The sole purpose of substantive consolidation is to ensure the equitable treatment of all creditors and courts have found the power to consolidate in the court’s general equitable powers in §105(a).

**Executory Contracts**

*Perlman v. Catapult Entertainment (In re Catapult Entertainment)*, 165 F.3d 747 (9th Cir. 1999). A debtor-in-possession cannot assume a nonexclusive patent license without the consent of the licensor. The plain language of §365(c)(1) links nonassignability under applicable law with a prohibition on assumption in bankruptcy.

*Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985). Technology licensing agreement was an executory contract capable of rejection by debtor under §365. Non-debtor would be entitled to treat rejection as a breach and seek money damages remedy. However, non-debtor could not seek to retain its contract rights in the technology by specific performance even if that remedy would ordinarily be available upon breach of this type of contract. Congress reacted by enacting §365(n), to allow a non-debtor licensee of intellectual property, upon rejection of the licensee agreement by the debtor/licensee, the option to “retain its rights” in the intellectual property, while continuing to pay royalties, or to treat the license as terminated and file a claim for damages.

*NLRB v. Bildisco and Bildisco*, 465 U.S. 513 (1984). The Supreme Court held that a collective bargaining agreement is an executory contract that may be rejected under Bankruptcy Code...
§365. After Bildisco was decided, Congress enacted Bankruptcy Code §1113, which sets forth the standards and procedures applicable to the rejection of, or interim change to, a collective bargaining agreement.

Notice

Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950). Practitioners frequently rely on notice by publication. This case sets forth the basic rules: Constitutional rights of due process require that notice of actions affecting a person’s property rights must be reasonably calculated, under all the circumstances, to apprise them of the pendency of the action and afford them an opportunity to present their objections. The reasonableness of a chosen method of notice may be justified by showing that it is reasonably certain to inform the affected parties or, failing that, that the chosen method is not substantially less likely to provide notice than other feasible substitutes. Notice by publication alone is not adequate if the affected parties and their whereabouts are known or could be ascertained with due diligence.

City of New York v. New York, New Haven & Hartford Ry. Co., 344 U.S. 293 (1953) In this Bankruptcy Act analog for Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, the Supreme Court held that notice by publication satisfies the requirements of due process only “when the names, interests, and addresses of persons are unknown.” Because the city of New York did not receive actual notice when it was a known creditor, the Court held that constructive notice by publication was insufficient and voided the order against the city.

Settlements

Archer v. Warner, 538 U.S. 314 (2003). Courts should look beyond the contractual nature of settlement agreement, which included release language, to determine whether a debt was for fiduciary fraud or defalcation under 523(a)(4).

Devlin v. Scardelletti, 536 U.S. 1 (2002). Retiree sought to intervene in class action to challenge settlement relating to his retirement plan. The United States District Court for the District of Maryland denied intervention, and retiree appealed. The Fourth Circuit affirmed the District Court’s denial of intervention and held that, because petitioner was not a named class representative and because he had been properly denied the right to intervene, he lacked standing to challenge the settlement. Retiree petitioned for certiorari, which was granted. The Supreme Court held that non-named class members who have timely objected to approval of a settlement at a fairness hearing may bring an appeal without first intervening. The Supreme Court stated that the issue, though framed by the Fourth Circuit as one of standing, does not implicate the jurisdiction of the courts, as petitioner satisfied both constitutional and prudential standing requirements. What was at issue was whether petitioner was a “party” for purposes of appealing the settlement approval, for only a lawsuit’s parties, or those that properly become parties, may appeal an adverse judgment.

Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414 (1968). In a case decided prior to the adoption of Bankruptcy Rule 9019, the Supreme Court found that in considering approval of a proposed settlement, the bankruptcy judge should...
consider “the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise.” Since the adoption of Bankruptcy Rule 9019, the TMT Trailer standard is still applicable. See In re Martin, 91 F.3d 389 (3d Cir. 1996).

Chapter 11 Plans

In re PPI Enterprises (U.S.) Inc., 324 F.3d 197 (3d Cir. 2003). The Third Circuit held that an alteration of a creditor’s rights imposed by the Bankruptcy Code itself (such as the limitation on a landlord’s damage claim imposed by Bankruptcy Code §502(b)(6)) rather than by a chapter 11 plan, does not constitute impairment for purposes of §1124.

In re Continental Airlines, 203 F.3d 203 (3d Cir. 2000). In Continental Airlines the Third Circuit considered the validity of a provision in the debtor’s plan of reorganization that released and permanently enjoined shareholder lawsuits against certain of debtor’s present and former directors and officers who were not themselves in bankruptcy. Because neither the bankruptcy court nor the district court made specific findings regarding the provision’s jurisdiction, factual basis or substantive legal authority, the Third Circuit reversed the district court’s order approving the validity of the provision and held the provision was legally and factually insupportable. There remains a split among the circuits that have considered this issue. The Ninth and Tenth Circuits have held that non-debtor releases were impermissible while the Second and Fourth Circuits have adopted a more flexible approach.

Bank of America Nat’l Trust and Sav. Ass’n v. 203 N. LaSalle Street Partnership, 526 U.S. 434 (1999). This is the second Supreme Court ruling under the Bankruptcy Code to define the limits of the “new value exception” to the absolute priority rule without deciding whether the new value exception actually exists. Prior to the enactment of the Bankruptcy Code, a class of equity holders could retain their interests in the debtor if the holders contributed new “money or money’s worth” to the reorganization. In Ahlers, the Court ruled that promises of future services by the current equity holders did not constitute money or money’s worth, and that the equity holders could not retain their interests without contributing new value even if those equity interests were worthless. 485 U.S. 197 (1988). In LaSalle, the Court ruled that a plan could not invoke the new value exception if the opportunity to contribute new value was given exclusively to the equity holders.

CoreStates Bank, N.A. v. Huls America, Inc., 176 F.3d 187 (3d Cir. 1999). When a claim arises pre-confirmation and could have been raised in the plan confirmation process but was not, claim and/or issue preclusion applies. In this case, the Third Circuit applied the framework for claim preclusion. Recognizing a circuit split on the issue, the Third Circuit agreed with the majority of the circuits including the Second, Sixth, and Ninth and concluded that claim preclusion applies regardless of whether the claim is considered a core or non-core “related” claim. The Fifth, and Seventh Circuits, however, have concluded that claim preclusion does not apply to non-core “related” jurisdiction.
**D&K Properties Crystal Lake v. Mutual Life Ins. Co. of NY, 112 F.3d 257 (7th Cir. 1997).** The Seventh Circuit held that blanket reservations of rights in a confirmed plan will not suffice to preserve causes of action in favor of the debtor. The court explained that a reservation must be express, both in writing and in identification. *D&K Properties* does not represent a universal rule. While some courts hold that Bankruptcy Code §1123(b)(3)’s retention provisions must specifically and unequivocally retain the action by identifying the cause of action and potential defendants by name, others hold that provisions containing a description of the type or category of claims are sufficiently specific and unequivocal.

**In re New Valley Corp., 168 B.R. 73 (Bankr. D. N.J. 1994).** The court held that Bankruptcy Code §1124(3) did not require a solvent debtor to pay post-petition interest on unsecured claims in order to have the class deemed unimpaired. Congress found the outcome of *New Valley* to be unfair and deleted Bankruptcy Code §1124(3).

**Windsor on the River Assocs. v. Balcor Real Estate Fin. (In re Windsor on the River Assocs.), 7 F.3d 127 (8th Cir. 1993).** The court held that a bankruptcy court, or a federal court sitting in bankruptcy, can dismiss a chapter 11 case if the debtor cannot propose a confirmable plan and if dismissal is in the best interest of creditors.

**In re SPM Mfg. Corp., 984 F.2d 1305 (1st Cir. 1993).** The First Circuit determined that a secured creditor may agree to give a portion of its recovery to the general unsecured creditors, bypassing priority claimants. While this case involved a chapter 7 liquidation, it has been used to support chapter 11 plans that transfer value to a junior class over the objection of an intervening class that rejected the plan. Under the absolute priority rule, the junior class would not otherwise be entitled to any recovery.

**Kane v. Johns-Manville Corp., 843 F.2d 636 (2d Cir. 1988).** The Second Circuit. Held that irregularities in voting rights are harmless error. A court must disregard any error or defect in the proceedings that does not affect substantial rights of the parties. A plan of reorganization meets confirmation requirements of §1129(a) and (b) where it is proposed in good faith, is in the creditor’s best interest, is feasible, and fair and equitable.

**Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).** Chapter 11 debtors, who operated family farm, appealed orders of the United States District Court for the District of Minnesota, concerning adequate protection payments. In this case, the Court of Appeals found that respondents’ promise of future “labor, experience, and expertise” permitted confirmation of their chapter 11 reorganization plan over the objections of their creditors, even though the plan violated the “absolute priority rule” of the Bankruptcy Code. Because this conclusion is at odds with the Code and other case law, the Supreme Court reversed. The Supreme Court held that the absolute priority rule, (which “provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan”) barred chapter 11 debtors’ retention of equity interest in farm over objections of creditors’ senior unsecured claims.
Subordination and Recharacterization of Claims

*United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213 (1996) 26 U.S.C. §4971(a)’s requirement to pay the IRS is considered a penalty, and therefore cannot be afforded “excise tax” priority. However, the court also finds that following *United States v. Noland*, the priority level assigned by Congress is not within the courts’ discretion. 517 U.S. 535, 116 S.Ct. 1524, 134 L.Ed.2d 748 (1996).

*In re Best Products Co., Inc.*, 68 F.3d 26 (2d Cir. 1995). The Second Circuit held that a bankruptcy court has jurisdiction to enforce a subordination agreement between two creditors who have filed proofs of claim. While the Supreme Court held in *Marathon Pipeline* that “non-core” private rights must be adjudicated by an Article III judge, §510(a) of the Bankruptcy Code provides for the enforcement of subordination agreements in bankruptcy to the same extent such agreements are enforceable under nonbankruptcy law and 28 U.S.C. §157(b)(2), which includes a non-exclusive list of proceedings deemed “core” by Congress, permits a bankruptcy court to consider matters concerning the administration of the estate. The Second Circuit concluded that although enforcement of subordination agreements is not specifically listed as a “core” proceeding, fixing the order of creditor priority is a core matter because it is essential to the administration of a bankruptcy estate. Therefore, since enforcement of the subordination agreement was necessary to administer the estate and fix priority of creditors who had filed proofs of claim, the bankruptcy court had jurisdiction over a core proceeding to enforce a contractual subordination agreement.

*United States v. Noland*, 517 U.S. 535 (1996). The Supreme Court reversed a decision that had subordinated tax penalty claims to the claims of other unsecured creditors. The Supreme Court ruled that Bankruptcy Code §510(c), which authorizes a court to subordinate claims based on equitable principles, may not be used to subordinate claims on a “categorical basis” such as this.

*In re Lifschultz Fast Freight*, 132 F.3d 339 (7th Cir. 1997). The Seventh Circuit held that undercapitalization does not, in and of itself, constitute the required misconduct to support equitable subordination without evidence that the insiders had deceived creditors as to the debtor’s financial condition or had engaged in other misconduct. The Seventh Circuit relied on the Fifth Circuit’s framework in *In re Mobile Steel Co.*, in which the first step of the analysis is to search for inequitable conduct. 563 F.2d 692 (5th Cir. 1977). Other courts have held that undercapitalization alone constitutes the required misconduct.

*In re Autostyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001). While recharacterization and equitable subordination may have, in practice, similar effects on a debt, the two remedies are theoretically distinct. The Sixth Circuit in *Autostyle Plastics*, found both to be valid doctrines. 269 F.3d 726 (6th Cir. 2001). However, the B.A.P. for the Ninth Circuit in *Pacific Express*, held that a bankruptcy court does not have the authority to recharacterize. 69 B.R. 112 (B.A.P. 9th Cir. 1986).
Environmental


Ohio v. Kovacs, 469 U.S. 274 (1985). A state’s order to clean up environmental damage is a “claim” that is subject to discharge in bankruptcy, at least where the debtor no longer has control over the property and the state is seeking a money judgment to enforce the order.

Professionals and Fees

In re United Artists Theater Co., 315 F.3d 217 (3d Cir. 2003). The Third Circuit was the first circuit court to address the propriety of professional’s indemnification clauses for work done in a debtor’s bankruptcy case. Noting that indemnification agreements for financial advisors were becoming a frequent market occurrence and that financial advisors were needed in the reorganization process, the Third Circuit found that the clause was reasonable under the circumstances. Indemnification clauses, however, continue to be objected to by the various offices of the United States Trustee.

In re Pillowtex, Inc., 304 F.3d 246 (3d Cir. 2002). The Third Circuit held when there is a facially plausible claim of a substantial preference to the debtor’s proposed counsel, the potential conflict must be resolved and cannot be avoided “by the mere expedient of approving retention conditional on a later determination of the preference issue.” Id. at 255. The Third Circuit found the conditions imposed by the lower court (that the firm law return any preference it might be determined to receive and waive any claim resulting from the preference) to be insufficient to approve the retention of the debtor’s law firm.

In re Marvel Entertainment Group, Inc., 140 F.3d 463 (3d Cir. 1998). After buyer of prepetition debt claims and bonds issued by holding companies owning Chapter 11 debtor’s stock obtained control of debtor’s board of directors, creditors sought appointment of trustee. Following withdrawal of the reference of cases of debtor and its affiliates, the United States District Court for the District of Delaware granted motion. Debtor-in-possession and controlling entities appealed. Trustee subsequently moved for order authorizing appointment of his law firm as trustee’s counsel, to which controlling entities objected. The District Court denied law firm’s appointment, and trustee appealed and sought mandamus relief. Appeals were consolidated and expedited. The Court of Appeals, held that: (1) Court had jurisdiction over appeals; (2) district court did not abuse its discretion when it determined that the bitterness between debtor-in-possession and creditors rose to level of “cause” necessitating trustee’s appointment; (3) trustee’s appointment was appropriate under Bankruptcy Code’s discretionary appointment provision; (4) district court erred in disqualifying law firm from serving as trustee’s counsel based on appearance of conflict of interest, not an actual conflict of interest; and (5) disqualification of law firm was abuse of discretion, given absence of either potential or actual conflict of interest.

In re Blackwood Associates, L.P., 153 F.3d 61 (2d Cir. 1998). Under a “carve-out” in the cash collateral order, professional fees are carved out for payment from those assets set aside to the secured creditor and paid before any claims. However, this stipulation needs to be a precise
carve-out. In *Blackwood Associates*, the Second Circuit construed the agreement such that highest priority was given to the adequate protection and tax escrow payments, not the professional fees. The result was that there was no cash collateral to pay the debtor’s counsel.

*In re Busy Beaver Building Centers, Inc.*, 19 F.3d 833 (3d Cir. 1994). The Third Circuit held under Bankruptcy Code §330 that the legal standard for assessing bankruptcy rates is comparable marketplace rates. *Busy Beaver* involved fees for paralegal work. The lower courts disallowed the fees. The Third Circuit reversed because comparable paralegal work was compensated in the marketplace. The Third Circuit directs courts to consider two specific types of evidence in determining the prevailing market rate: (1) comparison of “the costs of ‘equivalent’ practitioners of the art (including their billing structures),” and (2) comparison of the fee applicant’s rate to “the applicant’s billing practices with ‘equivalent’ clients.” *Id.* at 853.

*In re Leslie Faye Companies*, 175 B.R. 525 (Bankr. S.D.N.Y. 1994). Where counsel is retained to investigate actions of management and members of the board of directors, relationships with entities that have an interest in the investigation’s outcome or could exert pressure on investigating counsel must be disclosed. In this case, debtor’s counsel conducted an investigation regarding the actions of the debtor’s audit committee and prior to the investigation did not have any relationship with the debtor; however, concurrent with the investigation, debtor’s counsel maintained professional and personal relationships with parties that had an interest in the outcome of the investigation of the audit committee. The bankruptcy court found that debtor’s counsel was not disinterested when retained as required by §327(a); however, even after debtor’s counsel was found not to be disinterested, the firm was permitted to complete its work because it had performed its obligations competently and further delay would substantially harm the debtor.

*Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343 (1985). The Supreme Court held that the trustee of a corporate debtor has the power to waive the debtor’s attorney-client privilege with respect to pre-petition communications. In addition, the debtor’s directors do not have the right to assert the corporation’s privilege against the trustee.

**Sovereign Immunity**

*Tenn. Student Assistance Corp. v. Hood*, 541 U.S. 440 (2004). An undue hardship dischargability determination sought by a Chapter 7 debtor was not a suit against the State of Tennessee for purposes of the Eleventh Amendment; it was merely an exercise of the bankruptcy courts in rem jurisdiction.

*Seminole Tribe of Florida v. Florida*, 517 U.S. 44 (1996). Two previous Supreme Court decisions had determined that Bankruptcy Code §106 did not abrogate the United States’ or an individual state’s sovereign immunity. *U.S. v. Nordic Village, Inc.*, 503 U.S. 30 (1992); *Hoffman v. Connecticut Dept. of Income Maint.*, 492 U.S. 96 (1989). In reaction to these two decisions, Congress amended Bankruptcy Code §106 to provide an unequivocal waiver of state and federal sovereign immunity for most purposes under the Bankruptcy Code. In *Seminole Tribe*, however, a majority of the Court ruled that Congress does not have authority to abrogate a state’s sovereign immunity except under very limited Constitutional bases. *Seminole Tribe* was not a bankruptcy case, and the Supreme Court has not addressed Bankruptcy Code §106 since its
amendment, but the majority of circuit courts that have done so have interpreted *Seminole Tribe* to mean that §106 is unconstitutional as applied to the states. It is, however, a valid waiver of federal sovereign immunity.

*Administrative Expenses*

*Centerpoint Properties v. Montgomery Ward Holding Corp.*, 268 F.3d 205 (3d Cir. 2001). The majority of courts follow the proration approach, which accords administrative priority status to a landlord’s claim for reimbursement of taxes (on a daily accrual basis) depending on whether the landlord’s obligation to pay taxes accrued before or after the petition date. *E.g.*, *In re Handy Andy*, 144 F.3d 1125 (7th Cir. 1998). In *Montgomery Ward*, the Third Circuit rejected the proration approach, holding that *Bankruptcy Code* §365(d)(4) is unambiguous and requires a tenant to reimburse a landlord for any tax bill the landlord presents to the tenant in accordance with the lease terms so long as presentment occurs post-order for relief and pre-rejection. This split is tremendously important when choosing a venue, particularly if the debtor is a large lessee of real estate.

*In re CF &I Fabricators of Utah, Inc.*, 150 F.3d 1293 (10th Cir. 1998). The PBGC appears frequently as a creditor in chapter 11 cases. In *CF &I*, the Tenth Circuit determined that the PBGC’s claim for unpaid minimum funding contributions is not a tax entitled to priority under *Bankruptcy Code* §507(a)(8). The court also denied administrative expense priority to minimum funding obligations that came due after the petition date, except to the extent that those claims are based upon the post-petition labor of the debtor’s employees. As a further blow, the court determined that the amount of the PBGC’s claim for unfunded benefit liabilities should be determined using the same methods applied to valuing any other unsecured claim, rather than according to assumptions adopted by the PBGC under the authority of ERISA. The effect of this ruling is to allow the bankruptcy court to determine the amount of the unfunded benefit liabilities using a discount rate more favorable to the debtor than the rate used by the PBGC.

*In re Ames Dept. Stores, Inc.*, 115 BR 34 (S.D.N.Y. 1990). The court held that while §364 requires debtors to show that they have searched for unsecured credit before they can agree to a secured credit offer, it does not require that they seek credit from every possible source. The debtor must only show that it has made a reasonable effort to seek other sources of credit before the court will allow the debtor to obtain secured credit with an administrative priority.

*Avoidance Actions*

*Trans World Airlines*, 134 F.3d 188 (3d Cir.), *cert. denied*, 523 U.S. 1138 (1998). To determine insolvency for *Bankruptcy Code* §547(b) purposes, the Third Circuit determined that “going concern” valuation was appropriate because liquidation in bankruptcy was not clearly imminent. Contingent liabilities that would have been triggered by liquidation were not included.

*Barnhill v. Johnson*, 503 U.S. 393 (1992). For preference analysis the time of a transfer by check is upon its being honored and paid.
Union Bank v. Wolas (In re ZZZZ Best Co. Inc.), 502 U.S. 151 (1991). Bankruptcy Code §547 (c)(2) ordinary course of business exception applies not only to short-term debt payments, but also to long-term debt payments. The court found no significant difference between the two forms of credit as it applies to this exception. The ordinary course preference exception is applicable to long-term debt payments.


Langenkamp v. Culp, 498 U.S. 42 (1990). In this case and Granfinanciera, 492 U.S. 33, 58-59 (1989), the Supreme Court held that a defendant in a fraudulent transfer or preference action has a right to a jury trial if and only if the defendant has not filed a proof of claim in the bankruptcy case.

Begier v. I.R.S., 496 U.S. 53 (1990) Payments of trust fund taxes to IRS were not transfers of “property of the debtor” but instead transfers of property held in trust for the Government pursuant to §7501 (trust fund tax provision). Therefore, such payments cannot be avoided as preferences.


Asset Sales

In re O’Brien Environmental Energy, Inc., 181 F.3d 527 (3d Cir. 1999). The Third Circuit held that, under certain circumstances, the payment of break-up fees to a stalking-horse bidder is appropriate only if the fees are among the actual and necessary costs and expenses of preserving the estate and, therefore, qualify as administrative expenses within the meaning of Bankruptcy Code §503(b). However, it does not appear that the O’Brien test has brought about any significant change in actual practice in the Third or any other circuit.

Fairchild Aircraft Corp. v. Campbell (In re Fairchild Aircraft Corp.), 184 B.R. 910 (Bankr. W.D. Tex. 1995). The court held that the interests impacted by a sale free and clear under §363(f) are in rem interests that have attached to the property. Section 363(f) is not intended to extinguish in personam claims. This decision was self vacated three years later in Fairchild Aircraft Corp. v. Campbell (In re Fairchild Aircraft Corp.), 220 B.R. 909, 910 (Bankr. D. Tex. 1998), though the Honorable Judge Leif Clark, indicated his intent that his prior decision retain whatever precedential value it had.

In re Integrated Resources, Inc., 147 B.R. 650 (S.D.N.Y. 1992). Break-up fees, while standard and presumptively valid outside of bankruptcy, must be specifically approved by the bankruptcy court. While bankruptcy courts generally defer to a debtor’s business judgment when approving or disapproving of a debtor’s particular business decisions, bankruptcy courts sometimes take a harder look at breakup fees. The court in Integrated Resources set out an oft-cited tripartite test to evaluate breakup fees: (1) whether the negotiation was tainted by self-dealing or manipulation,
(2) whether the fee encourages or hampers bidding, and (3) whether the fee is reasonable relative to the proposed purchase price.

*In re Lionel Corporation, 722 F.2d 1063 (2d Cir. 1983)*. In what would become the standard for a Bankruptcy Code §363 sale, the Second Circuit determined that an ‘articulated business justification’ must be shown to support a sale of assets outside the ordinary course of business, and listed factors for a court to consider in connection with the approval of such a sale. The court noted that there was no statutory permission for sales of this type until 1937 and case law after 1937 utilized stricter standards, including: perishable, deterioration, or emergency.

**Miscellaneous**

*Figter Ltd. v. Teachers Ins. & Annuity Ass’n of Am. (In re Figter Ltd.), 118 F.3d 635 (9th Cir. 1997)* Ninth Circuit found that it was not in bad faith for Teachers to purchase the subordinate claims. Dealing in self-interest is not necessarily dealing in bad faith. Teachers was not a competitor, and was not acting to destroy Fitger’s business. Court stated that even if Teachers was acting with the intent to block Fitger’s plan confirmation it is still not considered bad faith. Also, the number of votes are determined and allotted to the claims associated with that class. Votes are not determined by the number of creditors, therefore Teachers was allowed a vote for every claim it bought (purchasing majority of unsecured claims against the debtor in order to establish a plan more favorable to the creditor is not bad faith)

*Celotex Corp. v. Edwards, 514 U.S. 300 (1995)* The Court upheld a bankruptcy court’s injunctions preventing execution on a surety bond by judgment creditors since the bankruptcy court had jurisdiction under 28 U.S.C. §§1334(b) and 157(a) over all matters “related to” the bankruptcy case and claimant’s proposed execution on the bond was “related to” the corporation’s bankruptcy.


*BFP v. Resolution Trust Corp., 511 U.S. 531 (1994)* The debtor brought a fraudulent transfer proceeding to avoid a mortgage foreclosure sale on the grounds that the price received at the foreclosure sale was less than the “reasonably equivalent value” of the property. The Supreme Court held that the price received at the foreclosure sale is the “reasonable equivalent value” for the property if the requirements of the state’s foreclosure laws have been met.

*Security Services, Inc. v. Kmart Corp., 511 U.S. 431 (1994)* Trustees in Bankruptcy and debtors-in-possession may rely on the filed rate doctrine to collect for undercharges but they may not collect for undercharges based on filed, but void, rates reported to Interstate Commerce Commission.

*Pioneer Inv. Services Co. v. Brunswick Assoc. Ltd. Partnership, 507 U.S. 380 (1993)* The issue in this case is “whether the trustee may contest the validity of an exemption after the 30-day period if the debtor had no colorable basis for claiming the exemption.” *Id.* at 639. It was held
that even though the trustee could have made an objection, the trustee’s “failure to do so prevents him from challenging the validity of the exemption now.” *Id.* at 642.


*Holywell Corp. v. Smith*, 501 U.S. 1279 (1991) The Supreme Court held that the Trustee in a Chapter 11 case must file income tax returns and pay taxes attributable to both a corporate debtors’ property (26 U.S.C. §6012(b)(3)) and an individual debtor’s property (26 U.S.C. §6012(b)(4)).


*Century Glove, Inc. v. First American Bank*, 860 F.2d 94 (3d Cir. 1988) Bankruptcy court was incorrect in its finding that FAB violated Bankruptcy Code §1125(b). The Bankruptcy court incorrectly held that solicitations of any information other than the chapter 11 plan or the disclosure statement must be approved by the court. Section 1125(b) is intended to regulate when the creditors may begin to solicit, and not what information they can solicit. Any further regulation on the creditors’ communication would undermine the Bankruptcy Code’s intentions.

*Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343 (1985) The Court held that the power to exercise the attorney-client privilege in bankruptcy proceedings passed to the bankruptcy trustee and that a trustee has the power to waive a debtor corporation’s privilege with respect to communications that took place prior to the filing of the bankruptcy petition.


*In re Metrocraft Pub. Services, Inc.*, 39 B.R. 567 (Bankr. N.D. Ga. 1984). A chapter 11 debtor applied for approval of its disclosure statement. Upon objection by the creditor’s committee, the court denied approval of the disclosure statement. The court examined 19 factors for evaluating the adequacy of a disclosure statement. Although the list of factors was not exhaustive and disclosure of all factors would not be necessary in every case, the factors provided the framework for the court’s analysis of the adequacy of the disclosure statement. The court held that the disclosure statement contained a number of deficiencies that must be corrected before it would approve the disclosure statement for distribution to creditors.

Bittner v. Borne Chemical Co. Inc., 691 F.2d 134 (3d Cir. 1982). The district court did not abuse its discretion by valuing stockholders’ claim based on the merits rather than its probability of success, even though that meant the claim was valued at zero. The district court’s finding was “consistent both with the claims’ present value and with the court’s assessment of the ultimate merits.” Id. at 139. The valuation was appropriate, even though it meant the stockholders lost the chance to have a significant voice in the reorganization process.