Legal Mojo | *Protect Your Position as a Creditor in the Bankruptcy Process*

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The COVID-19 pandemic accelerated and deepened the recession that was predicted to start in the latter half of 2020. One result was a significant number of bankruptcy filings, especially in sectors that were already struggling, with no sign that the pace will slacken in 2021. Your client unwittingly may be brought into another entity's bankruptcy case if a customer or vendor files for bankruptcy. It is important to understand some bankruptcy basics to help your creditor client understand the process and protect its interests while the client determines if hiring a bankruptcy specialist is necessary. This article addresses only events that commonly occur early in a bankruptcy case – it is by no means a comprehensive list of all the bankruptcy-related events that affect a creditors' interest, nor even a complete list of all the events that may occur early in the case.

1. Chapter 7 v. Chapter 11 – What's the Difference?

This article primarily focuses on cases filed under Chapter 11 of the U.S. Bankruptcy Code (the "Code"). A brief description of Chapter 7 is provided first to highlight certain differences.

a. Chapter 7

In a case filed under Chapter 7 of the Code, a trustee is immediately appointed from a panel of trustees who are approved by the U.S. Department of Justice. The trustee immediately takes control of the debtor's assets to liquidate them and distribute the proceeds equitably among the creditors in accordance with the priority scheme of the Code (generally, first to cover the costs of administering the bankruptcy estate, then to secured creditors, then to unsecured creditors, and lastly (but rarely) to equity). The trustee typically does not operate the debtor's business during the Chapter 7 case. A common exception is when the debtor is an energy exploration and production company ("E&P") whose assets would be lost or significantly diminished in value if operation ceased, or who would incur significant liabilities from a shutdown.

In most Chapter 7 cases, there is very little for a creditor to do, other than file a "proof of claim" and perhaps attend the "first meeting of creditors." If your client has a claim that could be non-dischargeable under Section 523 of the Code, it is advisable to consult promptly with a bankruptcy specialist to evaluate the viability of such a claim.

b. Chapter 11

There is much more variety in a Chapter 11 case. The debtor may choose to sell all or substantially all its assets as a "going concern" under Section 363 of the Code. Or it may engage in what is known as a "true reorganization," in which the debtor restructures its financing and then emerges as an operating entity. The debtor's business continues to operate during the case. Whether the Chapter 11 debtor engages in a sale process or a true reorganization, there are many more steps to a Chapter 11 case than in a Chapter 7 case. Accordingly, there are more instances in which a creditor must be cognizant of protecting its interests.

Adding further complexity to the Chapter 11 process is the availability of certain special procedures under the Small Business Reorganization Act of 2019 ("SBRA" also commonly known as "Subchapter V"), which went into effect on February 19, 2020. The SBRA modifies certain Chapter 11 procedures and makes certain statutory sections inapplicable to Subchapter V cases, with the goal of making these small business

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cases faster and less expensive than "traditional" Chapter 11 cases. In its original form, the SBRA was available to businesses with less than $2.7 million in debt. Under the Coronavirus Aid, Relief, and Economic Security Act, or CARES Act, the debt limit was raised to $7.5 million for cases filed before March 27, 2021. A comprehensive overview of the SBRA is a topic unto itself, but certain differences between a "traditional" Chapter 11 case and one under the SBRA are noted below.

2. First Things First

One of the first events in any bankruptcy case is the first meeting of creditors, often referred to as a "341 meeting" because it is conducted pursuant to Section 341 of the Code. It is scheduled anywhere from 21 to 50 days after the filing of the bankruptcy petition. Any party in interest can appear at the meeting (currently they are being conducted remotely), and parties do not have to be represented by attorneys. In Chapter 11 cases, a representative of the U.S. Trustee's office (the "Trustee") presides over the meeting; no judge is present.

The Trustee asks the debtor's representative (who is under oath) to confirm the information contained in the debtor's bankruptcy schedules and "statement of financial affairs," and may ask questions about the information contained in these documents (the "Documents"). Parties in interest also may ask questions related to the bankruptcy case or the debtor's financial position, including questions about (a) the information in the Documents, (b) the causes of the bankruptcy, and (c) the debtor's plan to exit bankruptcy. The questioning at the 341 meeting is not subject to federal discovery or evidentiary rules.

Another early event is the deadline for a creditor to file a proof of claim. In a traditional Chapter 11 case, the deadline to file is 180 days from the "order of relief" (defined as a voluntary petition or the date that the court orders the entry of an involuntary petition). In a Subchapter V case, however, the deadline to file a proof of claim is only 70 days from the order of relief. A creditor (even an entity) may file a proof of claim without an attorney, but depending on the nature of the creditor's claim, it may be advisable to hire a bankruptcy specialist to assist with the preparation of the proof of claim. The proof of claim should include as an attachment the proof of indebtedness and, for secured claims, the security instrument. The proof of claim is a judicial admission of the amount owed to the creditor, so it is important to be careful and accurate.

A proof of claim that is timely and properly filed is prima facie evidence of the claim's validity. However, the debtor may object to the claim, which will require a ruling from the bankruptcy court. The claim-objection proceeding may be a simple contested hearing, or if the dispute is more complex, the parties may follow certain federal adversary procedures. In this circumstance, the claim objection becomes a mini-trial within the overall bankruptcy case. In a contested claim proceeding, especially where adversary rules are invoked, it almost always is advisable to hire a bankruptcy specialist, if only to avoid a procedural misstep that could result in a waiver of the client's claim.

3. Dealing with Prepetition Litigation

Any litigation that is pending at the time the bankruptcy petition is filed is automatically stayed pursuant to Section 362 of the Code. The debtor should file a "suggestion of bankruptcy," including the "notice of filing" generated by the bankruptcy court, so that all parties and the court are aware of the imposition of the automatic stay. Once a bankruptcy case has commenced, the non-debtor party has several options.

The litigation may be removed to the bankruptcy court under 28 U.S.C. § 1452. Before filing a notice

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of removal on behalf of a non-debtor, you should consider (a) the limited subject-matter jurisdiction of the bankruptcy court, (b) the bankruptcy court's limited authority to enter final orders, and (c) the two-layer appeals process applicable to final bankruptcy court orders. The debtor also may remove the pending litigation to the bankruptcy court. If a case is removed to bankruptcy court, the process after removal -- including the procedure for seeking remand -- is set forth at 28 U.S.C. § 1447.

Alternatively, the non-debtor party may seek to lift the automatic stay. The bankruptcy court will consider various factors, including efficiency, jurisdictional limitations of the bankruptcy court, and whether a jury has been demanded. The automatic stay can be lifted for limited purposes. For example, the stay can be lifted so that a plaintiff may seek recovery from insurance proceeds *only* or so that the amount of a claim can be liquidated, with any recovery to occur through the normal bankruptcy process.

4. Creditor Beware: Clawback Actions under Chapter 5 of the U.S. Bankruptcy Code

Chapter 5 of the Code (not to be confused with the SBRA, which is Subchapter V of Chapter 11) permits the debtor to bring certain "clawback" actions against creditors and other parties for the purpose of augmenting the assets available for distribution to the creditor body as a whole. In a Chapter 7 case, the Trustee has the same powers.

The most common clawback actions are fraudulent transfer claims and preferential payment claims.

Fraudulent transfers can be asserted under 11 U.S.C. §§ 544 and 548, the latter of which incorporates by reference state-law fraudulent transfer actions. These actions do not require any bad intent on behalf of the transferee. Furthermore, the transfer does not have to include the transfer of cash. It can include the grant of a security interest or entry into a settlement agreement that included a release of claims against the "transferee."

Preferential payment, or transfer, claims are codified at 11 U.S.C. § 547 and are unique to the bankruptcy realm. In general, this section allows the debtor to recoup payments made outside the ordinary course of business in the 90 days prior to bankruptcy filing that give the transferee more than it would otherwise be entitled to under the Code. Payments under settlement agreements are a frequent target for preferential payment claims, as are payments on unsecured accounts that do not conform to a regular payment schedule.

The procedural and substantive law related to clawback litigation is in many ways unique to bankruptcy court. If your client is named as a defendant in a clawback action, it will certainly behoove him or her to engage a bankruptcy litigator.

5. Conclusion

Bankruptcy law and procedure are complex, and the cases can move quickly, especially in the early stages. Creditors can easily jeopardize their rights to repayment if they are unfamiliar with the bankruptcy process and do not engage experienced bankruptcy counsel. As we anticipate a lengthy and severe economic contraction in the U.S., having some familiarity with basic bankruptcy concepts will undoubtedly benefit your clients and possibly prevent significant adverse outcomes.

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