

“WHEN DO I NEED A BANKRUPTCY LAWYER?”

Some tips for General Counsel when bankruptcy issues arise

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Given today's difficult economic times, general counsel must be generally conversant with the rights of debtors and creditors. It will be the rare company that will pass through the span of a few years without being impacted by at least one bankruptcy. But when does your company need outside bankruptcy counsel? Are there any circumstances when a bankruptcy lawyer is unnecessary or not cost effective? Below are some of the most common bankruptcy issues confronting companies, and whether or not a bankruptcy lawyer is necessary to handle that issue.

Let's take a look at some bankruptcy basics to better understand where your issue might fit in the overall bankruptcy scheme:

What type of creditor is my company?

The threshold question confronting every creditor in bankruptcy is am I a secured creditor or an unsecured creditor? A secured creditor is one with a security interest in some collateral held by the debtor. The collateral may consist of the goods shipped by your company, some funds on deposit with the debtor's bank, or even real property owned by the debtor. Typically, a security interest is evidenced by a UCC-1 filing on file with secretary of state, or, in the case of real property, with a deed of trust recorded with the county where the real property is located. If your company is fortunate enough to have security for the money, goods, or services that it provided, it is governed by the bankruptcy rules related to secured creditors – and has a number of special protections unavailable to other creditors. Most importantly, secured creditors sit atop the bankruptcy priority scheme, i.e., they get paid first. Typically, if you have security you will likely need outside counsel's assistance in ensuring that your claim is appropriately treated in the bankruptcy. Outside counsel will be able to ensure that the specialized rules applicable to the treatment of secured claims are followed by the debtor or the bankruptcy trustee.

Far more common is the circumstance where the company does not have security, i.e., the money, goods, or services have been provided without requiring any form of security. In these cases, the company is an unsecured creditor. Unsecured creditors are roughly fourth in the bankruptcy priority scheme – behind secured creditors, creditors with administrative claims (people like the debtor's lawyers, or companies doing business with the debtor after the bankruptcy filing), and priority creditors (like taxing authorities and employee claims for back wages). Typically, unsecured creditors do not recover the full amount of their claim. Because the bankruptcy process is set up to address most types of unsecured claims, there are many times when unsecured creditors do not need a lawyer's assistance.

What kind of bankruptcy is it?

The Bankruptcy Code has several “Chapters” that relate to the type of relief that the debtor is seeking. In Chapter 7, the debtor is liquidating. The liquidation is overseen by a Chapter 7 trustee, a person appointed by the United States Trustee’s office that is charged with the fiduciary duty of converting the debtor’s remaining assets to cash for distribution to the debtor’s creditors in accordance with the priority scheme set up by the Bankruptcy Code. In the typical Chapter 7 situation, there will be little or no distribution to unsecured creditors. Not surprisingly then, no outside bankruptcy counsel is necessary in many Chapter 7 scenarios.

Alternatively, a debtor may seek relief under Chapter 11. In Chapter 11, the debtor is reorganizing (or selling) its business. In Chapter 11, the debtor’s current management typically runs the debtor for the benefit of the debtor’s creditors during the case. In Chapter 11, the debtor will propose a plan – typically within 120 days from the date that the debtor filed for bankruptcy – that sets forth its plan for paying its creditors. The plan, and the accompanying disclosure statement, constitute the debtor’s ‘new contract’ with its creditors and should specify the amount that a creditor can expect to recover. Understanding the debtor’s Chapter 11 plan, and the treatment of your company under the plan, is the most important objective in Chapter 11. Many times it is helpful to get outside counsel’s assistance in understanding your rights under the proposed Chapter 11 plan. Such assistance is usually critically important with respect to secured claims, and less so with respect to unsecured claims.

Issue #1 – Our company has not been paid, and we are unsecured.

This is the most common problem confronted by general counsel – your company is a creditor in a bankruptcy filed by one of its customers, clients, or vendors. The first thing that your company needs to know is the deadline for filing the proof of claim. In a Chapter 7, notice of this deadline is usually mailed very shortly after the case is filed and generally requires filing the proof of claim 90-100 days after the filing of the bankruptcy. In a Chapter 11, the claims bar date is set by the bankruptcy court and will be specially noticed by the court. Generally speaking, most Chapter 11 debtors’ lawyers like to have proofs of claim on file several weeks in advance of the filing of the Chapter 11 plan. This usually equates to a timeline anywhere between 45 days and 100 days after the filing of the Chapter 11.

Preparing and filing the proof of claim is largely a clerical task, and ordinarily does not require the assistance of bankruptcy counsel. The proof of claim is an official bankruptcy court form consisting of a few pages (that is uniform across the United States). The form can be filled out by someone in the accounting side of your organization. It may be mailed, or electronically filed with the bankruptcy court. Once on file, and provided that the debtor does not object to your claim, the filing of a proof of claim entitles your company to be paid its pro rata share of the distribution to unsecured creditors in the case. In a Chapter 7, there may be no such distribution, in a Chapter 11, the timing and amount of the distribution should be set forth in the disclosure statement that accompanies the debtor’s plan of reorganization.

Issue #2 – The debtor is in Chapter 11, it has a contract with my company and wants to do business with my company after the bankruptcy filing.

Whether your company needs outside counsel with respect to this question largely depends upon whether the contract you have with the debtor is “executory.” An executory contract, as that term has been interpreted under Section 365 of the Bankruptcy Code, means a contract that obligates both sides to some future performance. A contract where your company provides goods or services solely in exchange for payment will usually not qualify as an executory contract. In those circumstances, your company will likely not need outside counsel to manage this relationship. And, while doing business with a company in bankruptcy may not seem like an attractive option, there are a number of Bankruptcy Code provisions that make this a potentially beneficial deal for your company. First, the debtor must pay its post-bankruptcy obligations as they come due. If the debtor defaults on those obligations, your company may stop delivering goods and services and file an administrative claim under Section 503 of the Bankruptcy Code. Administrative creditors are second in line (after secured creditors) for repayment under the Bankruptcy Code’s priority scheme. Moreover, the Debtor must pay all administrative claims in full on the date the debtor exits Chapter 11 – meaning the debtor cannot reorganize without paying your company in full for the post-bankruptcy goods or services that your company provided. It should be noted, however, that if the debtor does refuse to pay for post-petition goods and services, you will likely need the assistance of a bankruptcy lawyer to file the motion for an administrative claim.

If the contract between your company and the debtor is executory, there are a number of fairly specialized rules that will come into play addressing the relative rights and obligations of the parties. In those circumstances, it is highly likely that your company will need the services of outside bankruptcy counsel to address the treatment that the debtor will propose for the contract. One of the easiest ways to know if your client is executory is if you receive a notification from the debtor (or the debtor’s lawyer) that your company cannot stop performance under the contract without violating the automatic stay imposed by the bankruptcy. That usually means that the debtor believes your contract is ‘executory’ and will seek to treat it under Section 365 of the Bankruptcy Code. The good news is that if the debtor wants your company to continue its performance, it has to pay for that performance. Moreover, if the debtor wants to assume your contract – keep it after the debtor exits bankruptcy – it has to cure any monetary defaults at the time of assumption. The bad news is that Section 365 allows a debtor to reject your contract, which would mean that your company only has an unsecured claim for breach of the agreement.

Issue # 3 – Your company is in a lawsuit with the debtor, who has now sought bankruptcy protection.

In this case, you likely already have outside counsel, so the question is whether you now need a bankruptcy specialist to assist. The answer to that question depends upon whether you believe that further litigation against the debtor will achieve your aims. As a threshold matter, it is important to note that once you receive notice of the bankruptcy you must cease and desist all litigation and/or attempts to collect against the debtor for pre-bankruptcy claims. A debtor in bankruptcy enjoys the protection of

the automatic stay under Section 362 of the Bankruptcy Code, which acts like an injunction prohibiting any actions against the debtor to collect pre-bankruptcy claims.

If your company needs the litigation to continue, it may petition the bankruptcy court to lift the automatic stay to allow the case to continue. Or, alternatively, your company can pursue its claim in the bankruptcy court as part of the bankruptcy claims process. In either case, your company will need the assistance of a bankruptcy specialist to ensure that it follows the appropriate procedures.

Occasionally, your company may decide that chasing a debtor that filed for Chapter 7 (where there is a very low chance of any positive recovery) makes no sense. In those cases, once the litigation ceases, the only thing remaining to do is file a claim. Under those circumstances, your company does not need a bankruptcy specialist.

Issue # 4 – The debtor owes our company money, but we have been sued by the debtor (or the Chapter 7 trustee)!

Your company will almost certainly need a lawyer if your company is sued by a Chapter 7 trustee, a Chapter 11 debtor-in-possession, or one of their successors. Under the Bankruptcy Code, the Chapter 7 trustee, or the Chapter 11 debtor-in-possession is charged with the fiduciary responsibility of administering all of the debtor's assets. Section 547 of the Bankruptcy Code provides that creditors that received payments on antecedent debt within 90 days before the bankruptcy filing may have received a preferential payment. That is, the creditor receiving such a payment immediately prior to the bankruptcy may actually be getting much more than other unsecured creditors by virtue of its 'last-minute' payment. Lawsuits to recover these 'preference' payments thus constitute an asset of the debtor's bankruptcy estate. The Bankruptcy Code provides that the debtor/trustee may bring these causes of action at any time two years after the filing of the bankruptcy.

There are a number of defenses to preference actions, the two most common being the 'new value' exception and the ordinary course exception. Under the 'new value' exception, the company would not be required to repay any amount that was payment for new goods and services provided contemporaneously with the payment. Under the 'ordinary course' exception, the company would not be required to repay any amounts that were made in the ordinary course of business according to ordinary business terms between the parties. Each of these defenses is fact-intensive and is essentially just like any other type of commercial litigation. Thus, outside counsel will be necessary to ensure that your company can mount an appropriate defense. Expect outside counsel's retainer to be in line with any other type of litigation with the preference payment's amount of exposure.

Closing remarks.

As set forth above, outside bankruptcy counsel will frequently be necessary to address the bankruptcy issues facing your company. The good news, however, is that the Bankruptcy Code was written to produce a high degree of certainty in commercial transactions involving distressed

companies. Accordingly, competent outside counsel ought to be able to provide general counsel with an appropriate timeline, a budget, and a range of anticipated outcomes.