Wolters Kluwer

CT

ESSENTIAL COMPLIANCE INSIGHTS

BANKRUPTCY BASICS FOR TRANSACTIONAL ATTORNEYS

Author Elina Balagula

"The "automatic stay" is an important concept that extends across all bankruptcy cases."

Since the onset of the COVID-19 pandemic, dozens of U.S. businesses in sectors such as retail, fitness, construction, and travel have filed for bankruptcy. Among known names on the list are Neiman Marcus, J. Crew, Gold's Gym, Virgin Atlantic, and many others.

There's also a growing fear that a second wave of the coronavirus – which is already trending with higher infection numbers – will bring a wave of foreclosures and force already struggling businesses into bankruptcy on a scale that could eventually surpass the financial crisis of 2008.

Against this backdrop, this article familiarizes transactional attorneys and paralegals with key bankruptcy concepts that may arise in dealings with clients who find themselves creditors in a bankruptcy case.

HISTORICAL BACKGROUND TO BANKRUPTCY

For some historical context, Article 1, Section 8 of the U.S. Constitution authorizes Congress to enact "uniform Laws on the subject of Bankruptcies through the United States." Congress enacted several bankruptcy acts since the early 1800s, until its adoption of the Bankruptcy Reform Act of 1978. The fundamental objective of bankruptcy laws is to give the debtor a "fresh start". This objective is accomplished through the discharge of certain debts through the bankruptcy process.

The Bankruptcy Reform Act established the Bankruptcy Code and independent bankruptcy courts. A federal law, the Bankruptcy Code is uniform across the U.S. and applies to all bankruptcy cases – unlike the Uniform Commercial Code, for example, that varies from state to state. Furthermore, the Federal Rules of Bankruptcy Procedure and Local Bankruptcy Court Rules govern the procedural aspect of the bankruptcy process.

Today the U.S. has a bankruptcy court for each judicial district in the country.

DISTRICT COURTS VS. BANKRUPTCY COURTS

There is a major difference between bankruptcy judges and district court judges. Even though both are federal judges, district court judges are Article III judges which means they have life tenure. They are nominated by the President and confirmed by the Senate. Bankruptcy judges are Article I judges which means they are appointed to 14-year terms by the majority of judges of the U.S. Court of Appeals.

In 1982, in a landmark decision (Northern Pipeline Construction Co. vs. Marathon Pipe Line Co. (458 U.S. 50)), the U.S. Supreme Court found that the bankruptcy courts did not have

continued on page 2

This information is not intended to provide legal advice or serve as a substitute for legal research to address specific situations.

© 2020 C T CORPORATION SYSTEM AND/OR ITS AFFILIATES. ALL RIGHTS RESERVED.

original jurisdiction over bankruptcy-related cases due to not being "independent" through life tenure appointments. As a result, Congress amended the Bankruptcy Act in 1984 to give bankruptcy judges the right to adjudicate bankruptcy cases and certain "core proceedings" defined in detail by 28 U.S.C. § 157, such as matters related to the administration of the estate and determinations of the validity or priority of liens

Today, district courts automatically refer bankruptcy cases and proceedings to the bankruptcy courts.

For non-core proceedings, bankruptcy judges must submit proposed findings of fact to the district courts.

SIX BASIC TYPES OF BANKRUPTCY CASES

There are six basic types of bankruptcy cases, as follows:

- Chapter 7: This is a court-supervised procedure for business entities and individuals, which involves a trustee taking over the assets of the debtor's estate, reducing them to cash, and making distributions to creditors, subject to secured interests and the debtor's right to retain some exempt property.
- Chapter 9: This encompasses reorganization (like Chapter 11) for municipalities
- Chapter 11: Perhaps one of the most well-known types of bankruptcy cases, Chapter 11 is usually used by business entities that wish to continue operations while repaying creditors through a court approved plan of reorganization.
- Chapter 12: Provides debt relief for family farmers and fishermen with regular income (like Chapter 13).
- Chapter 13: Designed for an individual debtor who has a regular source of income and enables the debtor to keep an asset, such as a house. However, the debtor must propose a plan to repay creditors over time – usually within 3-5 years.
- Chapter 15: Enacted in 2005, Chapter 15 offers a means of handling cross-border insolvency by enabling U.S. Bankruptcy Courts to recognize foreign insolvency procedures. For the purposes of this article, we'll focus on Chapters 7 and 11 as these typically apply to businesses where transactional attorneys may find themselves representing a secured party, or sometimes working as part of or alongside the Bankruptcy Group that is representing a debtor or a bankruptcy trustee.

WHO ARE THE PARTIES?

The parties generally involved in a bankruptcy case include:

- The debtor: The entity that filed for bankruptcy protection. The debtor is the borrower who owes money to its creditors.
- Secured creditor: A creditor who is owed a debt by the debtor and has a security interest in the debtor's asset(s). These types of creditors usually have a superior position to other creditors since their contracts with the debtor stipulate that in the event of non-payment they have claim to the proceeds of a particular type of collateral – such as real estate, inventory, or equipment.

"...this article familiarizes transactional attorneys and paralegals with key bankruptcy concepts that may arise in dealings with clients who find themselves creditors in a bankruptcy case."

- Unsecured creditor: A creditor who is owed by the debtor but doesn't have any collateral from which to get paid out. In other words, unsecured creditors simply have an "IOU" from the debtor. If the debtor doesn't pay, they have no recourse.
- U.S. trustee: The US Trustee program is a component of the U.S. Department of Justice responsible for overseeing the administration of bankruptcy cases. U.S. trustees supervise the administration of Chapter 7 and Chapter 11 cases and must abide by the Bankruptcy Code and Bankruptcy Rules.
- Trustee: A trustee may be assigned by the U.S. trustee to administer a bankruptcy case.

BANKRUPTCY TERMINOLOGY

The following terminology refers to all bankruptcy cases:

- Claim: Refers to a creditor's right to get paid. A claim may be liquidated, unliquidated, disputed, undisputed, fixed, contingent, matured, unmatured, legal, equitable, secured, or unsecured
- Secured claim: A claim that is secured by certain assets of the debtor up to the value of the lien on the collateral. Secured creditors have secured claims.

continued on page 3

This information is not intended to provide legal advice or serve as a substitute for legal research to address specific situations.

© 2020 C T CORPORATION SYSTEM AND/OR ITS AFFILIATES. ALL RIGHTS RESERVED.

- Unsecured claim: A claim that does not have underlying assets securing its payment. Sometimes a secured claim may be divided into two parts. For example, if a secured creditor is owed $100,000 and is secured by a certain piece of equipment that is worth $60,000, the secured creditor has two claims – a secured claim for $60,000 (the value of the collateral) and an unsecured claim for $40,000 (the remaining portion of the outstanding debt).
- Oversecured claim: A claim where the value of the underlying collateral exceeds the amount of the outstanding debt.
- Property of the estate: This refers to all legal interests of the debtor in property as of the time when the bankruptcy case is commenced, any property that a trustee recovers in bankruptcy, and any other property meeting the definition set forth in § 541 of the Bankruptcy Code. This is the aggregate pool of assets from which creditors will get paid out.

THE "AUTOMATIC STAY"

The "automatic stay" is an important concept that extends across all bankruptcy cases. As counsel for a secured creditor, a transactional attorney's instinct may be to send demand letters citing violations of the parties' agreements, but all bets are off once bankruptcy is filed. Generally, the reason any debtor would file for bankruptcy is because they aren't able to pay their obligations as they become due and are seeking relief from endless calls, letters, and possible threats from creditors. Bankruptcy affords them a way to either liquidate or reorganize their debt in an orderly fashion in line with the protections afforded by the Bankruptcy Code.

One of these protections is encompassed in § 362 of the Code which requires an automatic stay of all collection efforts by creditors upon bankruptcy filing. This means that creditors can't, without permission from the Bankruptcy Court, commence or continue any collection or recovery of assets, cannot continue or start lawsuits, and cannot record liens or exercise any setoff rights. From that point forward, all distribution of the debtor's assets will be governed by the Bankruptcy Code and the Bankruptcy Rules. Creditors will have an opportunity to assert their rights by filing claims and making any related assertions against the debtor's assets at such time and in such manner as the code and the rules prescribe.

This automatic stay remains in effect throughout the duration of the bankruptcy case unless the court deems a certain asset is not part of the case. For example, if a debtor leases a vehicle it is known that the vehicle is property of the lessor. While the lessor cannot repossess the vehicle after the bankruptcy case commences, in a Chapter 7 case the debtor will have 60 days to accept or reject the lease and, if the lease is rejected, the lessor will be allowed to proceed with repossession. When a secured creditor looks to foreclose on their collateral they must seek "relief from the automatic stay" to assert their rights, and the Bankruptcy Court will decide whether relief is warranted depending on the circumstances.

AVOIDANCE OF LIENS

When discussing bankruptcy, it is also important to be aware of the trustee's or the debtor-in-possession's rights to avoid certain liens that may have been valid and enforceable outside of bankruptcy.

This means that the trustee or the debtor-in-possession can ask the Bankruptcy Court to make certain liens unenforceable and thereby deem the proceeds of the underlying assets to be available to all creditors.

The following are instances in which a trustee may avoid liens:

- Liens not perfected before bankruptcy (§544(a)): The trustee holds the rights of a hypothetical lien creditor and may avoid unperfected liens (just like outside of bankruptcy a perfected lienholder will have priority over any unperfected lien). Furthermore, the trustee also holds the rights of a bona fide purchaser of real property, allowing it to void unrecorded liens on real property.
    - Practice Note: The trustee's powers under this section are a reminder to transactional attorneys why it is so important to ensure that all liens are perfected at the time they are recorded – a simple search to reflect would ensure that the lien is properly indexed in a state's UCC index so that the creditor's priority in bankruptcy can defeat that of the trustee.
- Liens that are avoidable "preferences" (§547): Subject to the terms of § 547, the trustee may avoid liens where such liens are deemed avoidable preferences, such as where a creditor obtained a new lien, perfected an

continued on page 4

This information is not intended to provide legal advice or serve as a substitute for legal research to address specific situations.

© 2020 C T CORPORATION SYSTEM AND/OR ITS AFFILIATES. ALL RIGHTS RESERVED.

existing lien, or obtained additional collateral in the 90-days before the filing of the bankruptcy case.

- Practice Note: It is presumed that the debtor has been insolvent 90 days prior to filing the petition. Therefore, it is imperative to be thorough in the due diligence process – such as running litigation and bankruptcy searches on the debtor and the guarantor(s), if any. Pay close attention to any potential warning signs and ask questions.

> Fraudulent Transfers (§548): Refers to the transfer of property for a lesser value within two years of bankruptcy (unless the state has longer terms). For example, if a debtor transferred $200,000 in real estate to a related party in exchange for $25,000, this would be a red flag and thus avoidable.

PRIORITY OF CLAIMS FOR BUSINESS ENTITIES (§ 507)

When debtors file for bankruptcy, usually there aren't enough assets for everyone to receive 100% of what they're owed. In fact, creditors rarely get paid close to that amount. It's not unusual for unsecured creditors to be paid as little as 10 cents on the dollar, if there are any funds left over to pay unsecured creditors at all.

It's important to also remember that pre-petition creditors aren't the only ones who must be paid. Creditors who do business with the debtor post-petition also need assurances that they'll be paid. The debtor must also pay its own attorney's fees. Finally, the trustee must be paid too.

The priority of payouts to creditors is dictated by the Bankruptcy Code. Here's how the priority of claims breaks down:

1. Secured claims: Secured claims will be afforded priority to the extent of the underlying collateral.
2. Priority administrative expenses: These are paid next, but only if they meet two requirements:
    - They were incurred post-petition by the debtor or trustee; and
    - They benefit or preserve the bankruptcy estate
3. General unsecured claims: These claims are entitled to distribution on a pro-rata basis with other general unsecured claims, only after payment of secured and priority administrative claims.

This is the general framework, but there are other exceptions and special types of claims – such as child support obligations and certain tax claims, that will trump other creditors. After payment on allowed claims is complete, the remaining debt will get discharged. However, certain claims are not dischargeable in bankruptcy and will continue to be the debtor's obligations even after the bankruptcy case closes.

LEARN MORE

To learn more about these key bankruptcy concepts and due diligence requirements that attorneys must consider in the context of bankruptcy, contact your CT representative.

This information is not intended to provide legal advice or serve as a substitute for legal research to address specific situations.

28 Liberty Street | New York, NY 10005 | 844-400-9804 | www.ctcorporation.com

1120

© 2020 C T CORPORATION SYSTEM AND/OR ITS AFFILIATES. ALL RIGHTS RESERVED.