

# STROOCK

A GUIDE TO THE BANKRUPTCY LAW  
OF THE UNITED STATES

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## BANKRUPTCY GUIDE

This Guide has been prepared by Andrew DeNatale, a partner in the Financial Restructuring Practice Group of Stroock & Stroock & Lavan LLP, as a reference guide to the Bankruptcy Act of 1978, 11 U.S.C. § 101 et seq., which is commonly referred to as the Bankruptcy Code. The firm hopes that it has accomplished its objective of providing a useful reference tool for lawyers not experienced in bankruptcy practice, as well as non-lawyers forced to deal in the complex area of bankruptcy cases.

Although great care has been taken to assure the accuracy and completeness of the material contained in this Guide, it is intended as a general reference guide only and does not purport to render legal or other professional advice. Additionally, this Guide does not address every provision of the Bankruptcy Code and Bankruptcy Rules or every issue that might arise in a bankruptcy case; instead, the Guide is limited to those material provisions that we believe are most relevant to our readers. When legal advice or other expert assistance is required, the reader should seek the services of a competent professional.

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STROOCK & STROOCK & LAVAN LLP  
180 Maiden Lane  
New York, NY 10038

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## Financial Restructuring Contacts

If you would like advice or assistance from Stroock & Stroock & Lavan LLP regarding any matter involving bankruptcy law, please direct your inquiry to one of the following attorneys in the Financial Restructuring Group.

Name	Title	Email	☎
DeNatale, Andrew P.	Partner	adenatale@stroock.com	212.806.6531
Gilad, Erez E.	Partner	egilad@stroock.com	212.806.5881
Ginsberg, Daniel P.	Special Counsel	dginsberg@stroock.com	212.806.6087
Handelsman, Lawrence M.	Of Counsel	lhandelsman@stroock.com	212.806.5426
Hansen, Kristopher M.	Partner	khansen@stroock.com	212.806.6056
Krieger, Arlene G.	Special Counsel	akrieger@stroock.com	212.806.5544
Kruger, Lewis	Partner	lkruger@stroock.com	212.806.5430
Lawrence, Brett	Partner	blawrence@stroock.com	212.806.5422
Lowenthal, Jeffrey S.	Partner	jlowenthal@stroock.com	212.806.5509
Mechling, Curtis C.	Partner	cmechling@stroock.com	212.806.5609
Millman, Sherry J.	Associate	smillman@stroock.com	212.806.5434
Olsen, Harold A.	Special Counsel	holsen@stroock.com	212.806.5627
Pasquale, Kenneth	Partner	kpasquale@stroock.com	212.806.5562
Schwartz, Matthew A.	Partner	mschwartz@stroock.com	212.806.5929
Shockey, George R.	Partner	gshockey@stroock.com	212.806.5848
Speiser, Mark A.	Partner	mspeiser@stroock.com	212.806.5437
Welkis, Scott	Partner	swelkis@stroock.com	212.806.5582
Wildes, Denise K.	Special Counsel	dwildes@stroock.com	212.806.6023



## TABLE OF CONTENTS



# Table of Contents

---

<b>I.</b>	<b>Overview.....</b>	<b>1</b>
	A. Background .....	1
	B. Provisions Governing Bankruptcy Law .....	2
<b>II.</b>	<b>The Bankruptcy Court System .....</b>	<b>7</b>
	A. Bankruptcy Courts and Judges.....	7
	B. Jurisdiction and Venue .....	8
	1. Jurisdiction .....	8
	2. Venue .....	10
	C. Abstention .....	12
	D. Sovereign Immunity.....	13
	E. Removal of Cases .....	14
	F. Role of the United States Trustee.....	14
<b>III.</b>	<b>Bankruptcy Court Procedures .....</b>	<b>17</b>
	A. Standing in Bankruptcy .....	17
	B. Disclosure .....	17
	C. Notice and Hearing.....	20
	D. Right to Jury Trial .....	21
	E. Motion Practice, Adversary Proceedings and Contested Matters .....	22
	1. Motion Practice.....	22
	2. Adversary Proceedings .....	23
	3. Contested Matters .....	23
	F. Compromise and Settlement .....	24
	G. Appeals .....	24
	H. Examinations in Bankruptcy.....	26
	1. Rule 2004 Examinations.....	26
	2. Meetings of Creditors .....	28
	I. Eligibility and Compensation of Trustees and Professionals .....	30
	1. Eligibility Requirements .....	30
	a. The Trustee .....	30
	b. Professionals .....	31
	2. Compensation .....	33

<b>IV.</b>	<b>Commencement of Bankruptcy Cases .....</b>	<b>39</b>
A.	Who May Be A Debtor .....	39
1.	Generally .....	39
2.	Means Testing .....	40
a.	Chapter 7 Means Test.....	40
b.	Chapter 13 Means Test.....	42
3.	Insolvency .....	43
B.	Type of Filing.....	44
1.	Voluntary Filing .....	44
2.	Involuntary Filing.....	45
C.	Procedural Matters.....	46
1.	Bankruptcy Petition.....	46
2.	Schedules and Statements.....	47
<b>V.</b>	<b>Administration of the Bankruptcy Case.....</b>	<b>51</b>
A.	Estate Fiduciaries – Debtors-in-Possession and Trustees .....	51
B.	Debtor’s Estate .....	51
1.	Property of the Estate .....	51
2.	Substantive Consolidation .....	54
C.	Automatic Stay .....	55
1.	General Protections and Limitations .....	55
2.	Specific Protections and Limitations .....	56
3.	Relief from the Automatic Stay .....	61
D.	Claims in Bankruptcy .....	63
1.	Definition of “Claim” .....	63
2.	Types and Priority of Claims.....	63
a.	Administrative Expense Claims .....	64
b.	Secured Claims.....	67
c.	Priority Unsecured Claims.....	68
d.	Non-Priority Unsecured Claims .....	70
e.	Subordination of Claims .....	70
3.	Setoff and Recoupment .....	73
a.	Setoff .....	73
b.	Recoupment .....	76
4.	Filing Proofs of Claim or Interest or Equity Holder.....	77
5.	Allowance of Claims or Interests .....	78
6.	Estimation of Claims.....	81
7.	Claims Trading.....	81



E.	Administrative Powers.....	82
1.	Adequate Protection.....	82
2.	Use, Sale and Lease of Property .....	83
a.	Generally .....	83
b.	Cash Collateral.....	84
c.	Asset Sales .....	85
3.	Assumption and Rejection of Executory Contracts and Unexpired Leases .....	88
a.	Generally .....	89
b.	Assumption .....	89
c.	Rejection.....	90
d.	Assumption and Assignment .....	92
e.	Miscellaneous.....	93
4.	Obtaining Postpetition Credit.....	95
5.	Utility Service .....	96
6.	Power of the Court .....	97
F.	Augmentation of the Estate .....	98
1.	Preferences .....	99
2.	Fraudulent Conveyances.....	102
3.	Strong-Arm Powers of the Trustee .....	104
4.	Postpetition Transactions .....	105
5.	Statutory Liens .....	107
6.	Limitations on Avoidance .....	108
7.	Turnover.....	109
8.	Recovery of Avoided Amounts .....	110
G.	Special Exceptions.....	113
1.	Swap Agreements, Commodity and Securities Contracts, Forward Contracts, Repurchase Agreements and Master Netting Agreements.....	113
a.	Overview.....	113
b.	Parties Protected by the Safe Harbor Provisions .....	115
c.	Safe Harbor Provisions .....	116
2.	Rejection of Collective Bargaining Agreements .....	118
3.	Aircraft Equipment and Vessels.....	122

<b>VI.</b>	<b>Reorganization (Chapter 11)</b> .....	<b>127</b>
A.	Debtor-in-Possession .....	127
B.	Chapter 11 Trustee and Examiner.....	127
C.	Operation of the Business .....	129
	1. Authorization to Operate the Business .....	129
	2. Ordinary Course of Business and the Business Judgment Rule .....	130
	3. Suits Against Fiduciaries for Actions Taken While Operating the Business .....	131
D.	Creditors' Committee.....	132
E.	Plan Solicitation and Disclosure Statement .....	134
	1. Plan Solicitation and Disclosure Statement .....	134
	2. Voting Rules .....	135
F.	Chapter 11 Plan.....	137
	1. Exclusivity .....	137
	2. Classification of Claims and Interests .....	138
	3. Treatment of Claims and Interests .....	138
	4. Mandatory Plan Provisions.....	139
	5. Permissive Plan Provisions .....	141
	6. Chapter 11 Liquidating Plans .....	142
	7. Modification of a Plan.....	142
G.	Plan Confirmation .....	143
	1. Consensual Confirmation.....	144
	2. Non-Consensual Confirmation .....	147
	a. Cramdown.....	147
	b. Cramup.....	150
	c. Entity Valuation .....	151
H.	Post-Confirmation Matters .....	152
	1. Effect of Confirmation .....	152
	2. Implementation of a Plan .....	153
	3. Third Party Releases and Injunctions .....	153
	4. Exemption from Securities Laws .....	155
	5. Special Tax Provisions .....	155
	a. Transfer Tax Exemption.....	155
	b. Net Operating Losses (NOLs).....	156
I.	Conclusion of the Case.....	158
	1. Closing.....	158
	2. Dismissal and Conversion to Chapter 7 .....	159
	3. Bad Faith Filings .....	160

<b>VII.</b>	<b>Liquidation (Chapter 7)</b> .....	<b>163</b>
A.	Generally .....	163
B.	The Chapter 7 Trustee .....	163
	1. Appointment and Election of Trustee .....	163
	2. Duties and Responsibilities of Trustee.....	165
C.	Collection, Liquidation and Distribution of the Estate.....	166
D.	Discharge of the Debtor and Denial of Discharge .....	167
E.	Non-Dischargeable Debts.....	170
F.	Stockbroker, Commodity Broker and Clearing Bank Liquidations .....	173
	1. Stockbrokers.....	173
	2. Commodity Brokers.....	176
	3. Clearing Banks .....	176
G.	Conclusion of the Case .....	176
	1. Generally.....	176
	2. Conversion and Dismissal .....	177
<b>VIII.</b>	<b>Adjustment of Debts of an Individual with Regular Income (Chapter 13)</b> .....	<b>181</b>
A.	Background .....	181
B.	Chapter 13 Debtors.....	181
C.	Automatic Stay.....	182
D.	Rights and Powers of Chapter 13 Trustee and Debtor .....	183
E.	Chapter 13 Plan .....	184
	1. Mandatory Plan Provisions .....	184
	2. Permissive Plan Provisions .....	185
	3. Treatment of Mortgages on the Debtor's Primary Residence .....	186
	4. Pre-Confirmation Modification of the Plan.....	187
F.	Confirmation of Plan .....	187
	1. Confirmation Hearing .....	187
	2. Confirmation Requirements.....	188
	3. Objections to Confirmation.....	190
	4. Plan Payments .....	191
	5. Post-Confirmation Modification of the Plan .....	192
G.	Effect of Confirmation and Discharge .....	192
	1. Effect of Confirmation.....	192
	2. Discharge .....	192
H.	Conversion or Dismissal .....	195

<b>IX.</b>	<b>Ancillary and Other Cross-Border Cases (Chapter 15).....</b>	<b>199</b>
A.	Purpose of Chapter 15.....	199
B.	Petition for Recognition of Foreign Proceeding.....	200
	1. Foreign Main Proceeding: Center of Main Interests (COMI).....	202
	2. Foreign Nonmain Proceeding: Establishment.....	202
C.	Effects of Recognition of Foreign Proceeding.....	203
	1. Relief in the Chapter 15 Proceeding.....	203
	2. Relief Outside the Chapter 15 Proceeding.....	204
D.	Involvement of U.S. Bankruptcy Estate Abroad.....	205
E.	Coordination of Concurrent U.S. and Foreign Proceedings.....	205
F.	Cooperation with Non-U.S. Courts and Foreign Representatives.....	205
<b>X.</b>	<b>Adjustment of Debts of a Municipality (Chapter 9) .....</b>	<b>209</b>
A.	Overview and Purpose of Chapter 9.....	209
B.	Eligibility to be a Chapter 9 Debtor.....	209
C.	Commencement of a Case.....	211
D.	Applicability of Automatic Stay and Certain Other Sections of the Bankruptcy Code.....	211
E.	Court's Limited Power.....	212
F.	Powers of the Debtor.....	213
G.	Creditors in a Municipal Bankruptcy.....	214
	1. Role of Creditors.....	214
	2. Claims.....	214
	3. Bondholders.....	214
H.	Chapter 9 Plan.....	215
I.	Plan Confirmation.....	215
J.	Effect of Confirmation and Discharge.....	217
K.	Conclusion of a Chapter 9 Case.....	217

TABLE OF AUTHORITIES



## Cases

---

<i>Allegiance Healthcare Corp. v. Primary Healthy Sys.</i> ( <i>In re Primary Health Sys.</i> ), 258 B.R. 111 (Bankr. D. Del. 2001) .....	109
<i>Austin Assocs. v. Howisan (In re Murphy)</i> , 288 B.R. 1 (D. Me. 2002) .....	17
<i>Bank of Amer. Nat'l Trust and Savings Ass'n v. 203 North LaSalle Street P'ship</i> , 526 U.S. 434 (1998) .....	150
<i>Barbosa v. Soloman</i> , 235 F.3d 31 (1st Cir. 2000) .....	181
<i>Barnhill v. Johnson</i> , 503 U.S. 393 (1992) .....	102
<i>Bonded Financial Services, Inc. v. European American Bank</i> , 838 F.2d 890 (7th Cir. 1988) .....	111
<i>Butner v. U.S.</i> , 440 U.S. 48 (1979) .....	4
<i>Cable v. Ivy Tech State College</i> , 200 F.3d 467 (7th Cir. 1999) .....	183
<i>Calyon N.Y. Branch v. Am. Home Mortg. Corp.</i> ( <i>In re American Home Mortgage, Inc.</i> ), 379 B.R. 503 (Bankr. D. Del. 2008).....	116
<i>Carter v. Rogers</i> , 220 F.3d 1249 (11th Cir. 2000).....	131
<i>Central Virginia Community College v. Katz</i> , 546 U.S. 356 (2006) .....	13
<i>Cinicola v. Scharffenberger</i> , 248 F.3d 110 (3d Cir. 2001).....	93
<i>Citizens Bank of Maryland v. Strumpf</i> , 516 U.S. 16 (1995) .....	57, 74
<i>City &amp; County of San Francisco v. PG&amp;E Corp.</i> , 433 F.3d 1115 (9th Cir. 2006).....	121
<i>Cohen v. KB Mezzanine Fund II, LP</i> ( <i>In re SubMicron Sys. Corp.</i> ), 432 F.3d 448 (3d Cir. 2006) .....	72, 73

*Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*,  
722 F.2d 1063 (2d Cir. 1983) ..... 86, 87

*Constant Ltd. Partnership v. Jamesway Corp.*,  
179 B.R. 33 (Bankr. S.D.N.Y. 1995)..... 22

*Cornerstone Prods., Inc. v. Pilot Plastics, Inc.*  
(*In re Cornerstone Prods., Inc.*), No. 05-53533, 2007 Bankr. LEXIS  
4101 (Bankr. E.D. Tex. Dec. 5, 2007) ..... 110

*Cybergenetics Corp. v. Chinery*,  
330 F.3d 548 (3rd Cir. 2003), cert. denied 124 S.Ct. 530 (2003) ..... 99

*Delta Airlines, Inc. v. Bibb*  
(*In re Delta Airlines*), 359 B.R. 454 (Bankr. S.D.N.Y. 2006)..... 76

*Doral Commerce Park, Ltd. v. Teleglobe Commc’ns Corp.*  
(*In re Teleglobe Commc’ns Corp.*), 304 B.R. 79 (D. Del. 2004)..... 90

*Dye v. Brown*  
(*In re AFI Holding, Inc.*), 355 B.R. 139 (9th Cir. B.A.P. 2006)..... 30

*El Paso v. America West Airlines, Inc.*  
(*In re America West Airlines, Inc.*), 217 F.3d 1161 (9th Cir. 2000) ..... 80

*Fairchild Aircraft, Inc. v. Cambell*  
(*In re Fairchild Aircraft Corp.*), 184 B.R. 910 (Bankr. W.D. Tex.  
1995) ..... 87

*Farrey v. Sanderfoot*,  
500 U.S. 291 (1991) ..... 107

*Florida Dep’t of Revenue v. Piccadilly Cafeterias, Inc.*,  
128 S.Ct. 2326 (2008) ..... 156

*Forman v. Jeffrey Matthews Fin. Group, LLC*  
(*In re Halpert & Co.*), 254 B.R. 104 (Bankr. D. N.J. 1999) ..... 103

*Frontier Bank v. Brown*  
(*In re Northern Merchandise, Inc.*), 371 F.3d 1056 (9th Cir. 2009) ..... 103

*Genuity Solutions, Inc. v. Metro. Trans. Auth.*  
(*In re Genuity, Inc.*), No. 02-43558, 2007 Bankr. LEXIS 2133  
(Bankr. S.D.N.Y. June 20, 2007) ..... 75

*Gitto v. Worcester Telegram & Gazette Corp.*  
(*In re Gitto Global Corp.*), 422 F.3d 1 (1st Cir. 2005)..... 18

*Goss v. Morgansen’s Ltd.*,  
No. 04-CV-0268, 2005 U.S. Dist. LEXIS 43600 (E.D.N.Y.  
Sept. 27, 2005) ..... 129



<i>Granfinanciera, S.A. v. Nordberg</i> , 492 U.S. 33 (1989) .....	21
<i>Hirsch v. Cahill</i> ( <i>In re Colonial Realty Co.</i> ), 210 B.R. 921 (Bankr. D. Conn. 1997) .....	104, 112
<i>Hong Kong and Shanghai Banking Corp., Ltd. v. Simon (In re Simon)</i> , 153 F.3d 991 (9th Cir. 1998) .....	8
<i>In re 203 N. LaSalle St. Ltd. Pshp.</i> , 190 B.R. 567 (Bankr. N.D. Ill. 1995).....	148
<i>In re Addison Community Hosp. Auth.</i> , 175 B.R. 646, 649 (Bankr. E.D. Mich. 1994).....	213
<i>In re Adelpia Bus. Solutions, Inc.</i> , 322 B.R. 51 (Bankr. S.D.N.Y. 2005) .....	89
<i>In re Adelpia Communications Corp.</i> , 327 B.R. 143 (Bankr. S.D.N.Y. 2005) .....	24
<i>In re Amanat</i> , 321 B.R. 30 (Bankr. S.D.N.Y. 2005) .....	45
<i>In re Amcor Funding Corp.</i> , 117 B.R. 549 (D. Ariz. 1990).....	114
<i>In re Analytical Sys., Inc.</i> , 71 B.R. 408 (Bankr. N.D. Ga. 1987) .....	28
<i>In re Armstrong World Indus.</i> , 348 B.R. 111 (Bankr. D. Del. 2006) .....	148
<i>In re Atlas Shipping A/S</i> , 404 B.R. 726, 744 n.16 (Bankr. S.D.N.Y. 2009).....	204
<i>In re Basis Yield Alpha Fund (Master)</i> , 381 B.R. 37 (Bankr. S.D.N.Y. 2008) .....	202
<i>In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.</i> , 374 B.R. 122.....	201, 202
<i>In re Best Prods. Co.</i> , 138 B.R. 155 (Bank. S.D.N.Y. 1992) .....	83
<i>In re Bison Resources, Inc.</i> , 230 B.R. 611 (Bankr. N.D. Okla. 1999) .....	81
<i>In re Bohlen Enters., Ltd.</i> , 859 F.2d 561 (8th Cir. 1988) .....	101

<i>In re Braniff Airways, Inc.</i> , 700 F.2d 935 (5th Cir. 1983) .....	87
<i>In re Brooklyn Overall Co., Inc.</i> , 57 B.R. 999 (Bankr. E.D.N.Y. 1986) .....	106
<i>In re C-TC 9th Ave. P'ship</i> , 113 F.3d 1304 (2d Cir. 1997) .....	160
<i>In re Continental Airlines, Inc.</i> , 203 F.3d 203 (3d Cir. 2000) .....	154
<i>In re Coram Healthcare Corp.</i> , 271 B.R. 228 (Bankr. D. Del. 2001) .....	130
<i>In re Countrywide Home Loans, Inc.</i> , 384 B.R. 373 (Bankr. W.D.Pa. 2008) .....	27
<i>In re Delta Airlines, Inc.</i> , 341 B.R. 439 (Bankr. S.D.N.Y. 2006) .....	73
<i>In re Designaire Modular Home Corp.</i> , 517 F.2d 1015 (3d Cir. 1975) .....	32
<i>In re Dow Corning Corp.</i> , 280 F.3d 648 (6th Cir. 2002) .....	154
<i>In re Drexel Burnham Lambert Group, Inc.</i> , 123 B.R. 702 (Bankr. S.D.N.Y. 1991) .....	28
<i>In re Durso Supermarkets</i> , 193 B.R. 682 (Bankr. S.D.N.Y. 1996) .....	43
<i>In re Edwards</i> , 207 B.R. 728 (Bankr. N.D. Fl. 1997) .....	194
<i>In re Emilio Cavallini, Ltd.</i> , 112 B.R. 73 (Bankr. S.D.N.Y. 1990) .....	89
<i>In re Enron Corp.</i> , 281 B.R. 836 (Bankr. S.D.N.Y. 2002) .....	27, 28
<i>In re Enron Corp.</i> , 306 B.R. 465 (Bankr. S.D.N.Y. 2004) .....	114
<i>In re Fucilo</i> , No. 00-36261, 2002 Bankr. LEXIS 475 (Bankr. S.D.N.Y. Jan. 24, 2002) ...	58
<i>In re G-I Holdings, Inc.</i> , 385 F.3d 313 (3d Cir. 2004) .....	128

<i>In re Gateway Access Solutions, Inc.</i> , 374 B.R. 556 (Bankr. M.D. Pa. 2007).....	159
<i>In re Heatherly</i> , 179 B.R. 872 (Bankr. W.D. Tenn. 1995).....	34
<i>In re Insilco Techs., Inc.</i> , 480 F.3d 212 (3d Cir. 2007).....	63
<i>In re Integrated Resources Inc.</i> , 147 B.R. 650 (Bankr. S.D.N.Y. 1992) .....	86, 130
<i>In re Integrity Supply, Inc.</i> , 417 B.R. 514 (Bankr. S.D. Ohio 2009).....	32
<i>In re Jack Greenberg, Inc.</i> , 189 B.R. 906 (Bankr. E.D. Pa. 1995).....	30
<i>In re Johns-Manville Corp.</i> , 36 B.R. 743 (Bankr. S.D.N.Y. 1984).....	17
<i>In re Johns-Manville Corp.</i> , 60 B.R. 612 (Bankr. S.D.N.Y. 1986).....	32
<i>In re Johns-Manville Corp.</i> , 68 B.R. 618 (Bankr. S.D.N.Y. 1986).....	147
<i>In re Kingston Square Assocs.</i> , 214 B.R. 713 (Bankr. S.D.N.Y. 1997) .....	160
<i>In re Kliegl Bros. Universal Elec. Stage Lighting Co.</i> , 149 B.R. 306 (Bankr. E.D.N.Y. 1992).....	148
<i>In re Kmart Corp.</i> , 359 F.3d 866 (7th Cir. 2004) .....	98
<i>In re Laguardia Assocs, L.P.</i> , 316 B.R. 832 (Bankr. E.D. Pa. 2004).....	10
<i>In re Lehman Brothers Holdings, Inc.</i> , No. 08-13555, 2010 Bankr. LEXIS 1260 (Bankr. S.D.N.Y. May 5, 2010) .....	118
<i>In re Lernout &amp; Hauspie Speech Prods., N.V.</i> , 301 B.R. 651 (Bankr. D. Del. 2003) .....	148
<i>In re Lunborg</i> , 110 B.R. 106 (Bankr. D. Conn. 1990).....	31
<i>In re Mailman Steam Carpet Cleaning Corp.</i> , 196 F.3d 1 (1st Cir. 1999), cert. denied, 530 U.S. 1230 (2000).....	166

<i>In re Manhattan Investment Fund LTD.</i> , 359 B.R. 510 (Bankr. S.D.N.Y. 2007).....	111
<i>In re Mendoza</i> , 111 F.3d 1264 (5th Cir. 1997) .....	191
<i>In re Miller</i> , 454 F.3d 899 (8th Cir. 2006) .....	106
<i>In re Mirant Corp.</i> , 326 B.R. 354 (Bankr. N.D. Tex. 2005) .....	28
<i>In re Mobile Steel Co.</i> , 563 F.2d 692 (5th Cir. 1997) .....	72
<i>In re Mount Carbon Metro. Dist.</i> , 242 B.R. 18, 35 (Bankr. D. Colo. 1999).....	216
<i>In re Murel Holding Corp.</i> , 75 F.2d 941 (2d Cir. 1935) .....	82
<i>In re Mushroom Transp. Co.</i> , 382 F.3d 325 (3d Cir. 2004) .....	86, 110
<i>In re Nellson Nutraceutical, Inc.</i> , 369 B.R. 787 (Bankr. D. Del. 2007).....	131
<i>In re New 118th, Inc.</i> , 398 B.R. 791 (Bankr. S.D.N.Y. 2009).....	156
<i>In re New Towne Dev., LLC</i> , 404 B.R. 140 (Bankr. M.D. La. 2009) .....	159
<i>In re O'Brien</i> , 181 F.3d 527 (3rd Cir. 1999) .....	86
<i>In re Okura &amp; Co.</i> , 249 B.R. 596 (Bankr. S.D.N.Y. 2000).....	75
<i>In re Overview Equities Inc.</i> , 240 B.R. 683 (Bankr. E.D.N.Y. 1999) .....	17
<i>In re Owens Corning</i> , 419 F.3d 195 (3d Cir. 2005) .....	55
<i>In re Oxford Homes, Inc.</i> , 204 B.R. 264 (Bankr. D. Me. 1997) .....	134
<i>In re Pacific Lumber Co.</i> , 584 F.3d 229 (5th Cir. 2009) .....	88, 150

<i>In re Pan Am Corp.</i> , 124 B.R. 960 (Bankr. S.D.N.Y. 1991) .....	123
<i>In re Philadelphia Newspapers, LLC</i> , 422 B.R. 553 (Bankr. E.D. Pa. 2010) .....	20
<i>In re Philadelphia Newspapers, LLC</i> , 599 F.3d 298 (3rd Cir. 2010) .....	88
<i>In re Pucci Shoes, Inc.</i> , 120 F.3d 38 (4th Cir. 1997) .....	106
<i>In re Recoton Corp.</i> , 307 B.R. 751 (Bankr. S.D.N.Y. 2004) .....	28
<i>In re Refco, Inc.</i> , 336 B.R. 187 (Bankr. S.D.N.Y. 2006) .....	19
<i>In re Revco D.S., Inc.</i> , 898 F.2d 498 (6th Cir. 1990) .....	129
<i>In re Rigden</i> , 795 F.2d 727 (9th Cir. 1986) .....	129
<i>In re Roco Corp.</i> , 701 F.2d 978 (1st Cir.1983) .....	103
<i>In re Roth Amer., Inc.</i> , 975 F.2d 949 (3d Cir. 1992).....	130
<i>In re RSM Richter Inc. v. Aguilar (In re Ephedra Products Liability Litig.)</i> , 349 B.R. 333 (S.D.N.Y. 2006) .....	200
<i>In re Sanitary &amp; Improv. Dist. No. 7</i> , 96 B.R. 966, 967 (Bankr. D. Neb. 1989) .....	213
<i>In re Semcrude, L.P.</i> , 399 B.R. 388 (Bankr. D. Del. 2009) .....	75, 76
<i>In re Semcrude, L.P.</i> , No. 08-11525, Docket No. 3465 (Bankr. D. Del. March 19, 2009).....	76
<i>In re Shondel</i> , 950 F.2d 1301 (7th Cir. 1991).....	158
<i>In re Smart World Techs., LLC</i> , 423 F.3d 166 (2d Cir. 2005).....	134
<i>In re Smyth</i> , 207 F.3d 758 (5th Cir. 2000) .....	166

<i>In re Southern Brewing Co.</i> , 117 F.2d 497 (5th Cir. 1941) .....	4
<i>In re SPM Mfg. Corp.</i> , 984 F.2d 1305 (1st Cir. 1993) .....	98, 132
<i>In re SphinX, Ltd.</i> , 351 B.R. 103, 117 (Bankr. S.D.N.Y. 2006) .....	202
<i>In re Squires Motel, LLC</i> , 416 B.R. 45 (Bankr. N.D.N.Y. 2009) .....	160
<i>In re STN Enters., Inc.</i> , 779 F.2d 901 (2d Cir. 1985) .....	99
<i>In re Stone</i> , No. 92-01383, 1998 Bankr. LEXIS 1976 (Bankr. D. D.C. Nov. 4, 1998) .....	131
<i>In re Suplinskas</i> , 252 B.R. 293 (Bankr. D. Conn. 2000) .....	159
<i>In re Swafford</i> , 160 B.R. 246 (Bankr. N.D. Ga. 1993) .....	108
<i>In re Texaco, Inc.</i> , 79 B.R. 551 (Bankr. S.D.N.Y. 1987) .....	27
<i>In re Trans World Airlines, Inc.</i> , 322 F.3d 283 (3rd Cir. 2003) .....	87
<i>In re United Press Int'l, Inc.</i> , 134 B.R. 507 (Bankr. S.D.N.Y. 1991) .....	120, 121
<i>In re US Airways Group, Inc.</i> , 287 B.R. 643 (Bankr. E.D. Va. 2002) .....	124
<i>In re Vienna Park Properties</i> , 120 B.R. 320 (Bankr. S.D.N.Y. 1990) .....	10
<i>In re W. Real Estate Fund, Inc.</i> , 922 F.2d 592 (10th Cir. 1991) .....	154
<i>In re Wabash Valley Power Ass'n</i> , 72 F.3d 1305 (7th Cir. 1995) .....	138
<i>In re Washington Mutual Inc.</i> , 419 B.R. 217 (Bankr. D. Del. 2009) .....	20
<i>In re Weiss</i> , 111 F.3d 1159 (4th Cir. 1997), <i>cert. denied</i> , 522 U.S. 950 (1997) .....	166

<i>In re Westpointe</i> , 241 F.3d 1005 (8th Cir. 2001).....	151
<i>In re White</i> , 126 B.R. 542 (Bankr. N.D. Ill. 1991).....	194
<i>Johnson v. Georgia Highway Express, Inc.</i> , 488 F.2d 714 (5th Cir. 1974) .....	35
<i>Kabro Assocs., LLC v. Colony Hill Assocs. (In re Colony Hill Assocs.)</i> , 111 F.3d 269 (2d Cir. 1997).....	17
<i>Kane v. Johns-Manville Corp.</i> , 843 F.2d 636 (2d Cir. 1988).....	25
<i>Kids World of Am., Inc. v. Georgia (In re Kids World of Am., Inc.)</i> , 349 B.R. 152 (Bankr. W.D. Ky. 2006).....	110
<i>Kitaeff v. Vappi &amp; Co.</i> , 140 B.R. 608 (Bankr. D. Mass. 1992) .....	74
<i>LaMonica v. North of England Protecting &amp; Indemnity Assn. (In re Probulk, Inc.)</i> , 407 B.R. 56 (Bankr. S.D.N.Y. 2009) .....	8
<i>Langenkamp v. Culp</i> , 498 US 42 (1990) .....	21
<i>Lebron v. Mechem Fin., Inc.</i> , 27 F.3d 937 (3d Cir. 1994).....	36
<i>Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Limited (In re Lehman Brothers Holdings, Inc.)</i> , 422 B.R. 407 (Bankr. S.D.N.Y. 2010) .....	114
<i>Livore v. Horgrave (In re Livore)</i> , No. 08-32423, 2010 Bankr Lexis 1653 (Bankr. D. N.J. May 6, 2010) .....	31
<i>Local Loan Co. v. Hunt</i> , 292 U.S. 234 (1934) .....	7
<i>Marrama v. Citizens Bank</i> , 549 U.S. 365 (2007) .....	177
<i>Martin v. Schapp Moving Sys., Inc.</i> , No. 97-5042, 1998 U.S. App. Lexis 15255 (2d Cir. 1998).....	27
<i>Moore v. New York Cotton Exchange</i> , 270 U.S. 593 (1926) .....	77
<i>Moran v. LTV Steel Co.</i> ( <i>In re LTV Steel Co.</i> ), 560 F.3d 449 (6th Cir. 2009) .....	25

xviii TABLE OF AUTHORITIES

*New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc.*  
(*In re Dairy Mart Convenience Stores, Inc.*) 351 F.3d 86 (2d Cir. 2003)..... 98

*Nickless v. Creare Inc. (In re Haverhill TechGrap)*,  
310 B.R. 478 (Bankr. D. Mass. 2004) ..... 12

*NLRB v. Bildisco & Bildisco*,  
465 U.S. 513 (1984) ..... 119

*Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*,  
458 U.S. 50 (1982) ..... 8, 21

*Northwest Airlines Corp. v. Ass’n of Flight Attendants*,  
483 F.3d 160 (2d Cir. 2007) ..... 121

*Norwest Bank Worthington v. Ahlers*,  
485 U.S. 197 (1988) ..... 7

*Nostas Assocs. v. Costich*  
(*In re Klein Sleep Prods.*), 78 F.3d 18 (2d Cir. 1996)..... 90

*Official Comm. of Unsecured Creditors of 360Networks (USA) Inc. v. AAF-  
McQuay, Inc.*  
(*In re 360Networks (USA) Inc.*), 327 B.R. 187 (Bankr. S.D.N.Y.  
2005) ..... 108

*Ownby v. Jim Beck, Inc.*  
(*In re Jim Beck, Inc.*), 214 B.R. 305 (Bankr. W.D. Va. 1997) ..... 147

*Peia v. Coan*,  
No. 3:05cv1029, 2006 U.S. Dist. LEXIS 12811 (D. Conn. March  
23, 2006)..... 131

*Regen Capital I, Inc. v. Halperin*  
(*In re U.S. Wireless Data, Inc.*), 547 F.3d 484 (2d Cir. 2008)..... 89

*Republic Credit Corp. I v. Boyer (In re Boyer)*,  
328 Fed. Appx. 711 (2d Cir. 2009) ..... 170

*Republic Supply Co. v. Shoaf*,  
815 F.2d 1046 (5th Cir.1987) ..... 154

*Roberts v. Boyajian (In re Roberts)*,  
279 B.R. 396 (B.A.P. 1st Cir. 2000) ..... 192

*Schwartz v. Aquatic Dev. Group, Inc.*,  
352 F.3d 671 (2d Cir. 2003) ..... 23

*Shubert v. Lucent Techs. Inc.*  
(*In re Winstar Commc’ns, Inc.*), 554 F.3d 382 (3d Cir. 2009) ..... 72



<i>Studley v. Boylston Nat'l Bank</i> , 229 U.S. 523 (1913) .....	73
<i>Summit Inv. &amp; Dev. Corp. v. Leroux</i> , 69 F.3d 608 (1st Cir. 1995) .....	93
<i>Till v. SCS Credit Corp.</i> , 541 U.S. 465 (2004) .....	150, 190
<i>Truck Drivers Local 807 v. Carey Transp. Inc.</i> , 816 F.2d 82 (2d Cir. 1987).....	119
<i>U.S. v. Bekins</i> , 304 U.S. 27 (1937) .....	209
<i>U.S. v. Dewey Freight Sys., Inc.</i> , 31 F.3d 620 (8th Cir. 1994) .....	77
<i>U.S. v. Maxwell</i> , 157 F.3d 1099 (7th Cir. 1998).....	73, 76
<i>United Airlines, Inc. v. HSBC Bank USA, N.A.</i> , 416 F.3d 609 (7th Cir. 2005) .....	89
<i>United Food and Commercial Workers Union, Local 328 v. Almac's, Inc.</i> , 90 F.3d 1 (1st Cir. 1996).....	121
<i>United Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd.</i> , 484 U.S. 365 (1998) .....	83, 167
<i>United States Trustee v. Bethlehem Steel Corp.</i> ( <i>In re Bethlehem Steel Corp.</i> ), No. 02 Civ. 2854, 2003 U.S. Dist. LEXIS 12909 (S.D.N.Y. July 23, 2003).....	86
<i>United States v. Whiting Pools</i> , 462 U.S. 198 (1983) .....	110
<i>Vanston Bondholders Protective Comm v. Green</i> , 329 U.S. 156 (1946) .....	4
<i>Vass v. Conron Bros. Co.</i> , 59 F.2d 969 (2d Cir. 1932).....	131
<i>Video Software Dealers Ass'n v. Orion Pictures Corp.</i> , 21 F.3d 24 (2d Cir. 1994) .....	18
<i>Von Gunten v. Neilson</i> ( <i>In re Slatkin</i> ), 243 Fed. Appx. 255 (9th Cir. 2007).....	75
<i>W.R. Grace &amp; Co. v. Libby Claimants</i> , No. 08-246, 2008 U.S. Dist. LEXIS 86958 (D. Del. Oct. 28, 2008) .....	97

*Yerushalmi v. Pergament (In re Yereushalmi)*  
2010 Bankr. Lexis 454 (Bankr. E.D.N.Y. Feb. 12, 2010).....25

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Charles Warren, *Bankruptcy in United States History* (1972).....1  
Vern Countryman, *Executory Contracts in Bankruptcy, Part 1*, 57 Minn. L.  
Rev. 439, 460 (1973) ..... 88

# I

OVERVIEW



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# I. Overview

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## A. Background

Pursuant to the Article 1, Section 8, Clause 4 of the United States Constitution, Congress has the authority to “establish ... uniform laws on the subject of bankruptcies throughout the United States.”

From the beginning, “every financial crisis and period of depression has been attended by the passage of stay-laws by State Legislatures and by pressure on Congress for bankruptcy legislation.” See Charles Warren, *Bankruptcy in United States History* (1972). Responding to this pressure, Congress has enacted a total of five separate bankruptcy statutes: (i) the Bankruptcy Act of 1800, which was repealed in 1803; (ii) the Bankruptcy Act of 1841, which was repealed in 1843; (iii) the Bankruptcy Act of 1867, which was repealed in 1878; (iv) the Bankruptcy Act of 1898, which was amended by the Chandler Amendment in 1938 and repealed in 1978; and (v) the Bankruptcy Reform Act of 1978, as amended, which is the current law.

The current statute governs cases commenced on or after October 1, 1979. Important amendments to the Bankruptcy Reform Act of 1978 were made pursuant to the Bankruptcy Amendments and Federal Judgeship Act of 1984 (the “1984 Amendments”); the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986; the Bankruptcy Reform Act of 1994 (the “1994 Amendments”); the Religious Liberty and Charitable Donation Protection Act of 1998; and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “2005 Amendments”). Changes were also made to implement provisions of the Retiree Benefit Protection Act of 1988. The Bankruptcy Reform Act of 1978, as amended, is codified in 11 U.S.C. §§ 101–1532, and is generally referred to as the “Bankruptcy Code” or “Title 11.”

As our national bankruptcy law has evolved, it has sought to balance important, yet often conflicting principles. On the one hand, modern bankruptcy law seeks to provide an honest debtor with a fresh start or to foster rehabilitation of the debtor through provisions such as the automatic

stay and discharge of the debtor.<sup>1</sup> On the other hand, the law seeks to promote equality of distribution among competing creditors through provisions such as preferences and fraudulent conveyances.

As will be discussed in more detail later in this Guide, upon the commencement of a bankruptcy case, the person or entity subject to bankruptcy becomes known as a “debtor” and all of its interests in property become part of a separate legal entity known as a “bankruptcy estate.” During a bankruptcy case, this estate is managed by an estate fiduciary. Depending on the type of bankruptcy case and the nature of the debtor, this estate fiduciary typically is either the existing management of the debtor (a so-called “debtor-in-possession”) or a third party appointed for the specific purpose of managing the bankruptcy estate (a “trustee”). Although various Sections of the Bankruptcy Code refer solely to a trustee, in the context of a Chapter 11 case, such a reference generally also encompasses a debtor-in-possession as the Bankruptcy Code provides that the latter generally has the same rights, powers and duties as the former.

## B. Provisions Governing Bankruptcy Law

The provisions governing bankruptcy law are found in (1) the Bankruptcy Code, (2) the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules,” cited as “Fed. R. Bankr. P.”), and (3) assorted other statutes relating to bankruptcy matters.

The Bankruptcy Code is divided into the following Chapters:

- Chapter 1: General Provisions
- Chapter 3: Case Administration
- Chapter 5: Creditors, the Debtor, and the Estate
- Chapter 7: Liquidation
- Chapter 9: Adjustment of Debts of a Municipality

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<sup>1</sup> It should be noted that the 2005 Amendments, in an effort to curb certain perceived abuses, contained provisions which have in some ways made it more difficult for a debtor to obtain a fresh start or rehabilitate itself. These provisions include means-testing for eligibility of individuals in Chapter 7 cases and the imposition of strict limits on the debtor’s exclusive period to file a plan in Chapter 11 cases and to assume or reject leases of non-residential real property.

- Chapter 11: Reorganization
- Chapter 12: Adjustment of Debts of a Family Farmer or Fisherman with Regular Annual Income
- Chapter 13: Adjustment of Debts of an Individual with Regular Income
- Chapter 15: Ancillary and Other Cross-Border Cases

As a general rule, Chapters 1, 3 and 5 apply in cases under Chapter 7, 11 or 13. Chapter 1 and Sections 307, 362(n), 555 through 557, and 559 through 562 apply in Chapter 15 cases. Except for those specific Sections referenced in Section 901, only Chapters 1 and 9 apply in a Chapter 9 case. *See generally* 11 U.S.C. § 103.

The Bankruptcy Rules govern procedure in cases under the Bankruptcy Code and consist of the following general categories:

- Part I: Commencement of Case; Proceedings Relating to Petition and Order for Relief
- Part II: Officers and Administration; Notices; Meetings; Examinations; Elections; Attorneys and Accountants
- Part III: Claims and Distribution to Creditors and Equity Interest Holders; Plans
- Part IV: The Debtor: Duties and Benefits
- Part V: Courts and Clerks
- Part VI: Collection and Liquidation of the Estate
- Part VII: Adversary Proceedings
- Part VIII: Appeals to District Court or Bankruptcy Appellate Panel
- Part IX: General Provisions

The Bankruptcy Rules also include a collection of Official Forms. The Bankruptcy Rules are supplemented by local rules promulgated in each judicial district.

The Bankruptcy Rules are revised by the United States Supreme Court (the “U.S. Supreme Court”) from time to time pursuant to authority granted to it under 28 U.S.C. § 2075. The most recent amendments to the Bankruptcy Rules became effective on December 1, 2009.

Other statutes affecting bankruptcy law include (i) numerous provisions of the Judicial Code, title 28 of the United States Code, including those relating to jurisdiction (§ 1334), venue (§§ 1408, 1409, 1410), jury trials (§ 1411), change of venue (§ 1412), removal of causes of action (§ 1452), bankruptcy judges (§§ 151–157), appeals (§ 158), bankruptcy fees (§ 1930), United States Trustees (§§ 581–589), duties of the Director of the Administrative Office of the United States Courts concerning the panel of private trustees (§ 604), trustees suable (§ 959), and bankruptcy rule-making authority (§ 2075); and (ii) various provisions of Crimes and Criminal Procedure, title 18 of the United States Code, relating to bankruptcy crimes.

Finally, it is worth noting that while bankruptcy cases are governed in the first instance by the Bankruptcy Code, Bankruptcy Rules, local bankruptcy rules and other Federal statutes (as discussed above), issues arising in bankruptcy are often resolved pursuant to applicable nonbankruptcy law, both Federal and State. *See Vanston Bondholders Protective Comm v. Green*, 329 U.S. 156 (1946). For example, with respect to the allowance of claims under Section 502, the bankruptcy court must initially analyze whether a debt exists under State law. *See id.* Nevertheless, even if the analysis of claims is originally rooted in State law, it does not end there, and questions of allowance and priority are ultimately governed by bankruptcy law. *See In re Southern Brewing Co.*, 117 F.2d 497, 500-01 (5th Cir. 1941). Similarly, the determination of what constitutes property of the estate under Section 541 of the Bankruptcy Code is an inquiry that begins under State law. *See, e.g., Butner v. U.S.*, 440 U.S. 48, 55 (1979); *In re Southern Brewing Co.*, 117 F.2d at 500.



# II

THE BANKRUPTCY COURT SYSTEM



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## II. The Bankruptcy Court System

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### A. Bankruptcy Courts and Judges

The creation of separate bankruptcy courts is a relatively recent occurrence when compared to the long history of bankruptcy law in the United States. Under the Bankruptcy Act of 1898 (which was amended numerous times and governed bankruptcy cases for approximately eighty years), the district court was vested with jurisdiction over bankruptcy cases. The district court, in turn, routinely referred bankruptcy matters to “referees in bankruptcy.” Although the referee exercised much of the judicial authority of the district court, the district court remained the “court of bankruptcy.”

Bankruptcy courts are essentially “courts of equity and their proceedings are inherently proceedings in equity.” *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934). However, these equitable powers “must and can only be exercised within the confines of the Bankruptcy Code.” *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988).

Pursuant to the Bankruptcy Code, each judicial district in the United States has established within it a separate bankruptcy court, which is a unit of the district court. 28 U.S.C. § 151. Bankruptcy judges, who receive their power through Article I (rather than Article III) of the United States Constitution,<sup>2</sup> are appointed to the bankruptcy court by the applicable United States Court of Appeals and sit for a term of fourteen years. 28 U.S.C. § 152(a). As discussed below under Jurisdiction and Venue, the bankruptcy judge’s authority still derives, at least in part, from the district court.

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<sup>2</sup> By creating the bankruptcy courts pursuant to Article I of the Constitution (legislative power) rather than Article III (judicial power), the powers granted to bankruptcy judges (including their tenure and the scope of the matters they can determine) are restricted as compared to Article III judges.

## B. Jurisdiction and Venue

### 1. Jurisdiction

As part of the Bankruptcy Reform Act of 1978, Congress originally attempted to impart bankruptcy judges with jurisdictional power equivalent to that provided to Article III judges, but without granting them Article III status. In *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), the U.S. Supreme Court held this to be unconstitutional as a violation of the Constitutional separation of powers. Thereafter, as part of the 1984 Amendments, Congress developed the current jurisdictional scheme for bankruptcy courts, in which it narrowed the scope of the bankruptcy courts' power.

Although most bankruptcy matters are heard by the bankruptcy courts, it is the district courts, not the bankruptcy courts, that are granted original jurisdiction over bankruptcy matters. 28 U.S.C. § 1334(a)–(b). In particular, district courts are granted original and exclusive jurisdiction over cases under title 11 and original, but not exclusive, jurisdiction over civil proceedings arising under title 11 or arising in or related to cases under title 11. *Id.* As part of the grant of exclusive jurisdiction over cases under title 11, the district court in which such a case is commenced is also granted exclusive jurisdiction over “all of the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate.” 28 U.S.C. § 1334(e)(1). This has been interpreted to extend to property located worldwide, although the practical effectiveness of such broad jurisdiction depends upon the courts' ability to exercise jurisdiction over the parties. *See, e.g., Hong Kong and Shanghai Banking Corp., Ltd. v. Simon (In re Simon)*, 153 F.3d 991, 996–97 (9th Cir. 1998); *LaMonica v. North of England Protecting & Indemnity Assn. (In re Probulk, Inc.)*, 407 B.R. 56, 61 (Bankr. S.D.N.Y. 2009).

Notwithstanding the original grant of jurisdiction to the district courts, the district courts are authorized (but not required) to refer bankruptcy matters to the bankruptcy courts, 28 U.S.C. § 157(a), and most district courts have entered standing orders which accomplish this automatically. However, such reference may (and in certain cases must) be withdrawn by the district

court “for cause shown.” In particular, the reference must be withdrawn if the proceeding involves both title 11 and other U.S. laws regulating organizations or activities affecting interstate commerce. 28 U.S.C. § 157(d).

The level of decision-making authority which a bankruptcy court possesses over a particular bankruptcy matter depends on whether or not such matter (i) is a case under title 11, a proceeding arising under title 11, or a proceeding arising in or related to a case under title 11 and (ii) is a core or non-core proceeding. In particular, bankruptcy 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. 28 U.S.C. § 157(b)(1). This includes the power of the bankruptcy judge to enter formal orders or judgments on those matters. Unless all parties consent to the determination of a non-core, related matter by the bankruptcy court, non-core matters that are otherwise related to a title 11 case may be heard by a bankruptcy judge, but the judge is only permitted to submit proposed findings of fact and conclusions of law to the district court for determination by the district court. 28 U.S.C. § 157(c)(1)–(2). In such a situation, the district court is to consider the bankruptcy judge’s proposed findings of fact and conclusions of law and review de novo those matters to which a party timely and specifically objected. 28 U.S.C. § 157(c)(1).

Whether a matter is core or non-core, but related is determined by the bankruptcy judge and cannot be made solely on the basis that resolution of such matter may be affected by State law. 28 U.S.C. § 157(b)(3). Examples of core matters include, among other things: case administration matters; most claim allowance or disallowance matters; financing orders; avoidance actions; automatic stay matters; dischargeability matters; determinations of the validity, extent or priority of liens; plan confirmation; use, sale or lease of property (including use of cash collateral); and recognition of foreign proceedings. 28 U.S.C. § 157(b)(2). Personal injury tort and wrongful death claims, on the other hand, are to be heard by the district court for the district in which the bankruptcy case is pending or the district court for the district in which the claim arose, as determined by the district court in the district in which the bankruptcy case is pending. 28 U.S.C. § 157(b)(5).

## 2. Venue

Whereas jurisdiction deals with the power of a court to hear a particular matter, venue addresses which geographic judicial district is the proper one for a particular case or proceeding. Venue of a bankruptcy case (other than a Chapter 15 case ancillary to a foreign proceeding) is proper either in the district (i) in which the debtor is domiciled, resides, has its principal place of business in the United States or has its principal assets in the United States during the 180-day (or the longest portion of the 180-day) period before commencement of the case or (ii) in which there is pending a bankruptcy proceeding for an affiliate, general partner or partnership of the debtor. 28 U.S.C. § 1408. For a corporation, this will generally mean that venue is proper either in its State of incorporation or where its principal place of business is located. The principal place of business is determined by where significant business decisions are made, sometimes referred to as the “nerve center” of the corporation. *In re Vienna Park Properties*, 120 B.R. 320, 327 (Bankr. S.D.N.Y. 1990). Where business decisions are made in a State that does not contain the principal place of business under the foregoing test, venue may be proper in either state. *In re LaGuardia Assocs, L.P.*, 316 B.R. 832 (Bankr. E.D. Pa. 2004).

Venue of Chapter 15 cases ancillary to foreign proceedings is proper in the district (i) in which the debtor has its principal place of business or principal assets in the United States (without any temporal condition as required for non-ancillary cases), (ii) if no place of business or assets are located in the United States, the district in which there is pending against the debtor an action or proceeding in Federal or State court, or (iii) if neither (i) nor (ii) immediately above applies, the district in which “venue will be consistent with the interests of justice and convenience of the parties, having regard to the relief sought by the foreign representative.” 28 U.S.C. § 1410.

Subject to certain exceptions, proceedings arising under, arising in or related to a bankruptcy case can be heard in the district court in which the underlying bankruptcy case is pending. 28 U.S.C. § 1409. These exceptions are:

- (i) a proceeding by the trustee<sup>3</sup> arising in or related to a title 11 case to recover a money judgment of or property worth less than \$1,175<sup>4</sup> or a consumer debt of less than \$17,575 or a non-consumer debt against a non-insider of less than \$11,725, which must be commenced in the district court for the district in which the defendant resides;
- (ii) subject to (i) above, a proceeding by a trustee, acting as statutory successor to the debtor or creditors, under either Section 541 (property of the estate) or 544(b) (granting the trustee the rights of actual, unsecured creditors under applicable nonbankruptcy law to void transfers) of the Bankruptcy Code arising in or related to a title 11 case, which may be brought in the district court for the district where the Federal or State court sits in which venue would have been proper under applicable nonbankruptcy law;
- (iii) a proceeding by the trustee arising under title 11 or arising in or related to a case under title 11 based on a claim arising after the commencement of the bankruptcy case and relating to the operation of the debtor’s business, which must be brought in the district court for the district where a Federal or State court sits in which venue would have been proper under applicable non-bankruptcy law; and

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<sup>3</sup> As explained further in Chapters I.A. and VI.A., in the Chapter 11 context, the Bankruptcy Code’s reference to a “trustee” also encompasses a debtor-in-possession. A discussion of the debtor-in-possession is located in Chapter VI.A. below.

<sup>4</sup> Many of the dollar amounts contained in the Bankruptcy Code and the Judicial Code are adjusted periodically. The dollar amounts set forth in this Guide reflect the relevant dollar amounts for cases commenced after April 1, 2010.

- (iv) a proceeding against the representative of the bankruptcy estate arising under title 11 or arising in or related to a case under title 11 based on a claim arising after the commencement of the bankruptcy case and relating to the operation of the debtor's business, which may be brought in either (a) the district court for the district where a Federal or State court sits in which venue would have been proper under applicable non-bankruptcy law or (b) the district court in which the bankruptcy case is pending.

A district court may transfer a case or proceeding under title 11 to another district, "in the interest of justice or for the convenience of the parties." 28 U.S.C. § 1412. The procedure governing the transfer of cases is set forth in Bankruptcy Rule 1014(a).

### C. Abstention

Abstention refers generally to the doctrine whereby a Federal court having jurisdiction declines to exercise such jurisdiction. In certain instances, abstention is permissive, whereas in other situations it is mandatory. As it relates to bankruptcy matters other than Chapter 15 cases ancillary to foreign proceedings, district courts are permitted to abstain from hearing a proceeding arising under title 11 or arising in or related to a case under title 11 "in the interest of justice, or in the interest of comity with State courts or respect for State law." 28 U.S.C. § 1334(c)(1). District courts must abstain from hearing civil proceedings related to a case under title 11 where such related proceeding could not have been commenced in Federal court but for the bankruptcy, such proceeding is the subject of a State court action and the action can be timely adjudicated in the State court. 28 U.S.C. § 1334(c)(2). These provisions apply equally to the bankruptcy courts. *Nickless v. Creare Inc. (In re Haverhill TechGrap)*, 310 B.R. 478 (Bankr. D. Mass. 2004).

Proceedings relating to the estimation of personal injury tort and wrongful death claims for distribution purposes are deemed non-core matters pursuant to 28 U.S.C. § 157(b)(2)(B) and are carved out from the mandatory abstention provisions of 28 U.S.C. § 1334(c)(2). 28 U.S.C. § 157(b)(4). As noted above, these claims are to be heard by a district court.



Except for decisions not to abstain in a situation requiring mandatory abstention as described above, decisions regarding abstention under these Sections may only be appealed to the district court or the bankruptcy appellate panel and are not reviewable by the circuit courts or the U.S. Supreme Court. 28 U.S.C. § 1334(d).

It should be noted that these Sections do not deal with the ability of a court to abstain from adjudicating a bankruptcy case itself, but just particular matters within a bankruptcy case. The ability of a court to abstain from hearing a bankruptcy case itself is dealt with in Section 305 of the Bankruptcy Code, which provides that a bankruptcy case may be dismissed or suspended if “the interests of creditors and the debtor would be better served by such dismissal or suspension.” 11 U.S.C. § 305.

## D. Sovereign Immunity

Although the doctrine of sovereign immunity generally prevents a governmental entity from being sued in Federal court, the Bankruptcy Code provides for certain exceptions to this doctrine as it relates to bankruptcy matters. For example, a governmental unit that files a proof of claim in a bankruptcy case is deemed to have waived sovereign immunity with respect to a claim against such unit that arises out of the same transaction or occurrence as the governmental unit’s claim. 11 U.S.C. § 106(b). Furthermore, setoffs against claims of governmental units are also permitted. 11 U.S.C. § 106(c).

Section 106 of the Bankruptcy Code also annuls sovereign immunity with respect to a number of provisions of the Bankruptcy Code, including Sections pertaining to the automatic stay (§ 362), use, sale or lease of property (§ 363), obtaining credit (§ 364), executory contracts and unexpired leases (§ 365), avoidance actions (§§ 544, 547–550), and effect of confirmation (§ 1141). 11 U.S.C. § 106(a). Although the effect of Section 106(a) in respect of claims against the Federal government has not been called into question, there had been some debate over the constitutionality of Section 106(a) as it relates to claims against State governments. However, in the 2006 decision of *Central Virginia Community College v. Katz*, 546 U.S. 356 (2006), the U.S. Supreme Court resolved this issue by upholding Section 106(a) as it applies to State governments.

## E. Removal of Cases

As a general matter, the doctrine of removal pertains to the ability to move a case or proceeding from one court to another court, most typically from State court to Federal court. There are two statutory Sections for removal that apply in bankruptcy—28 U.S.C. § 1441 (the general removal provision) and 28 U.S.C. § 1452 (the removal provision for matters related to bankruptcy cases). Of these, the more commonly utilized avenue is 28 U.S.C. § 1452(a), which provides that 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 its police or regulatory power to the district court for the district where such civil action is pending, provided that such district court has jurisdiction over such claim or cause of action under 28 U.S.C. § 1334. The procedure governing the removal of actions is set forth in Bankruptcy Rule 9027.

Notwithstanding the power of removal, the court to which an action is removed may remand it back to the original court on any equitable ground. 28 U.S.C. § 1452(b). A decision to remand or not to remand may only be appealed to the district court or the bankruptcy appellate panel and is not reviewable by the circuit courts or the U.S. Supreme Court.

## F. Role of the United States Trustee

The United States Trustees (“U.S. Trustees”) are an arm of the United States Department of Justice and are charged with overseeing the administration of bankruptcy cases as well as with advancing the efficiency and integrity of the bankruptcy system. Pursuant to 28 U.S.C. § 581, a different U.S. Trustee is appointed for each of twenty-one different regions in the United States. Each U.S. Trustee may have one or more assistants. 28 U.S.C. § 582. Although many of the duties of the U.S. Trustee are administrative (such as overseeing the appointment of official committees and reviewing fee applications), Section 307 of the Bankruptcy Code permits the U.S. Trustee to raise, appear and be heard on any issue in any bankruptcy case or proceeding (except that they cannot file a plan).

# III

BANKRUPTCY COURT PROCEDURES



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## III. Bankruptcy Court Procedures

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### A. Standing in Bankruptcy

Standing refers generally to the ability of a party to appear and be heard in particular case or proceeding. At least in the Chapter 11 context, in order for an individual or entity to have standing, such individual or entity must be a “party in interest” in the bankruptcy proceeding. 11 U.S.C. § 1109(b). This means that such individual or entity must have a direct financial or legal stake in the outcome of the case or be the representative of such an individual or entity. *In re Johns-Manville Corp.*, 36 B.R. 743 (Bankr. S.D.N.Y. 1984); *In re Overview Equities Inc.*, 240 B.R. 683 (Bankr. E.D.N.Y. 1999). As set forth in Section 1109(b), examples of parties in interest include the debtor, trustee or debtor-in-possession, creditors committee, creditor, equity security holder and indenture trustee. In addition, the U.S. Trustee also has standing to be heard on any issue in a bankruptcy case or proceeding. 11 U.S.C. § 307. Although the right to raise issues and be heard in a bankruptcy case is generally broadly interpreted, one category of party to which such right is generally not granted is losing bidders at sale auctions under Section 363 of the Bankruptcy Code as such parties are not considered to have an economic or legal stake in the outcome. *See Austin Assocs. v. Howisan (In re Murphy)*, 288 B.R. 1, 4 (D. Me. 2002). However, prospective bidders at a 363 sale have been permitted to object to bidding procedures. *See Kabro Assocs., LLC v. Colony Hill Assocs. (In re Colony Hill Assocs.)*, 111 F.3d 269, 247 (2d Cir. 1997).

### B. Disclosure

One significant change that occurs upon a bankruptcy filing and may take parties in interest (including the debtor itself) by surprise is the level of openness and disclosure involved in a bankruptcy proceeding. These disclosure requirements apply even if the party in interest was not required to disclose such information under applicable nonbankruptcy law prior to the bankruptcy filing. Thus, for example, private companies that file for bankruptcy will be subject to a much higher level of disclosure in bankruptcy than outside bankruptcy.

As a general matter, all papers filed in a bankruptcy case as well as the case docket itself are publicly available for review. 11 U.S.C. § 107(a). Furthermore, both the Bankruptcy Code and Bankruptcy Rules mandate that certain disclosures be made by various parties in interest. For example, every debtor is required to file very detailed schedules of assets and liabilities and statements of financial affairs as well as various reports detailing certain financial information. See Fed. R. Bankr. P. 1007(b), 2015; 11 U.S.C. § 704(a)(8). Moreover, as part of the plan confirmation process, a debtor is also required to file a disclosure statement containing “adequate information,” discussed below at Chapter VI.E. Finally, as part of standard motion practice, the movant will need to provide sufficient factual justification for the relief requested, which can include information that it would not normally disclose publicly.

Particularly surprising can be the fact that such disclosures may often require the inclusion of information that would be considered confidential outside of the bankruptcy context, such as the commercial terms of a transaction between the debtor and a third party. Although the Bankruptcy Code and Bankruptcy Rules provide that some sensitive information can be filed “under seal” such that only certain parties can view it, only certain types of information are covered. See 11 U.S.C. § 107(b); Fed. R. Bankr. P. 9018 (covering trade secrets, confidential research, development and commercial information and scandalous and defamatory matters). Furthermore, courts will often narrowly construe these provisions. See *Gitto v. Worcester Telegram & Gazette Corp. (In re Gitto Global Corp.)*, 422 F.3d 1, 8 (1st Cir. 2005). Finally, the burden of proof is on the party requesting that the information be protected from public view. See *Video Software Dealers Ass’n v. Orion Pictures Corp.*, 21 F.3d 24, 27 (2d Cir. 1994). Thus, the baseline position is that information is to be disclosed.

Although the great bulk of the disclosure obligations fall on the debtor, it is important to note that creditors and other parties in interest also can be subject to additional disclosure requirements in a bankruptcy proceeding. For example, just as with a debtor, when a creditor files a motion, it will also be required to support its request for relief with a sufficient factual predicate, which, as noted above, may necessitate the disclosure of information that would normally not be subject to public scrutiny. In addition, as part of the 2005 Amendments, official committees must now “provide access to” information to creditors represented by, but not appointed to, the committee.

11 U.S.C. § 1102(b)(3). This can result in a much wider distribution of information regarding a debtor than previously existed even in bankruptcy proceedings. Some courts, however, have recognized the impact that this can have on a debtor's ability to keep information confidential (at least until the appropriate time) if interpreted broadly and, accordingly, have restricted a committee's duty under this Section to exclude the provision of access to confidential or proprietary information. See, e.g., *In re Refco, Inc.*, 336 B.R. 187 (Bankr. S.D.N.Y. 2006).

Equally significant are the disclosure obligations put on certain parties in interest in cases under Chapters 9 and 11 pursuant to Bankruptcy Rule 2019. Currently, Bankruptcy Rule 2019(a) provides that, other than official committees, every entity or committee in a Chapter 9 or Chapter 11 case that represents multiple creditors or equity security holders and, unless directed otherwise by the bankruptcy court, every indenture trustee must disclose detailed information, including (i) the names and addresses of the creditors or equity security holders, (ii) the nature and amount of the claims or equity interests and the times of acquisition thereof (unless alleged to have been acquired more than one year prior to the petition date), (iii) certain facts regarding the employment of the entity or indenture trustee filing the statement and, in the case of a committee, the names of the entities, directly or indirectly, who arranged the employment or organized the committee and (iv) the amounts of claims or equity interests owned by the entity filing the statement, the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefor and any sales thereof.

The statement must also include a copy of the instrument, if any, by which the entity, committee or indenture trustee is empowered to act on behalf of the creditors or equity security holders and supplemental statements must be filed promptly upon any material changes in the facts previously disclosed pursuant to Bankruptcy Rule 2019. Fed. R. Bankr. P. 2019(a). Parties who fail to file a so-called "2019 Statement" can be subject to certain penalties, including being barred from further appearances in the bankruptcy case or having any acceptances, rejections or objections given, procured or received by them held invalid. Fed. R. Bankr. P. 2019(b).

Recently, a significant debate has developed regarding whether Bankruptcy Rule 2019 should apply to so-called "unofficial" or "ad hoc" committees, who, while representing themselves, do not purport to act for

any other party in the bankruptcy case. Compare *In re Washington Mutual Inc.*, 419 B.R. 217 (Bankr. D. Del. 2009) (holding that Bankruptcy Rule 2019 applies to unofficial committees) with *In re Philadelphia Newspapers, LLC*, 422 B.R. 553 (Bankr. E.D. Pa. 2010) (holding that Bankruptcy Rule 2019 does not apply to unofficial committees).

As a result of, among other things, this debate, in August 2009 the Advisory Committee on the Federal Rules of Bankruptcy Procedure proposed a significant amendment to Bankruptcy Rule 2019. The proposed amendment was modified in May 2010, and, as of the publication date of this Guide, the Advisory Committee on the Federal Rules of Bankruptcy Procedure unanimously recommended that the most recent, proposed changes to Bankruptcy Rule 2019 be approved. However, the revised rule must be approved by the Standing Committee on Rules of Practice and Procedure, the Judicial Conference of the United States, the U.S. Supreme Court, and Congress before it becomes effective.

Finally, another way in which disclosure in bankruptcy is much broader than outside of bankruptcy is in the breadth of discovery that is permitted pursuant to Bankruptcy Rule 2004, discussed below at Chapter III.H.1.

### C. Notice and Hearing

One of the hallmarks of the U.S. legal system is the doctrine of “due process,” which generally means that a party to a legal action is entitled to certain fundamental protections. One such right is the right of the party to receive notice of a proceeding that might impact, among other things, its property. This is an especially important issue in the bankruptcy context given the nature of bankruptcy proceedings. As such, the Bankruptcy Code and Bankruptcy Rules set forth various procedures to assure that parties in interest receive adequate notice of relevant matters. In particular, it is often necessary, before a court may approve an action, for notice of the matter to be provided to some or all of the parties in interest in the bankruptcy case and for there to be an open hearing on the matter. Both the notice and the opportunity for a hearing must be “appropriate in the particular circumstances.” 11 U.S.C. § 102(1)(A). Specified notice periods for various actions are set forth both in the Bankruptcy Rules and Local Bankruptcy Rules. See, e.g., Fed. R. Bankr. P. 2002.



Nonetheless, an act requiring court approval can be authorized without an actual hearing if notice is proper and either (i) a hearing is not timely requested by a party in interest or (ii) there is insufficient time for a hearing to be commenced before such act is required to be done, and the court authorizes such act. 11 U.S.C. § 102(1)(B).

## D. Right to Jury Trial

The Seventh Amendment to the United States Constitution provides for the right to a jury trial for “suits at common law.” As bankruptcy courts are courts of equity, and not of law, there has been some disagreement over whether the right to a jury trial applies in bankruptcy. In the case of *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989), the U.S. Supreme Court held that the right to a jury trial applies in bankruptcy, at least in the context of an action to recover a fraudulent conveyance, which the Court characterized as a legal, and not an equitable, action.<sup>5</sup> In addition, subsequent to the U.S. Supreme Court decision in *N. Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), there was also some doubt regarding the extent to which bankruptcy judges, as Article I judges, have the power to conduct jury trials. In order to address this confusion, the 1994 Amendments specifically authorized bankruptcy judges to conduct jury trials of matters which may be determined by the bankruptcy court and where the bankruptcy judge is specially designated to exercise such jurisdiction by the district court and all parties to the matter expressly consent. 28 U.S.C. § 157(e).

Notwithstanding that the right to a jury trial vests pursuant to the United States Constitution, there are certain ways in which such right can be lost. The U.S. Supreme Court has held that the filing of a proof of claim in a bankruptcy proceeding effects a waiver of a creditor’s right to a jury trial (if any) on matters within the core jurisdiction of the bankruptcy courts. See *Langenkamp v. Culp*, 498 US 42 (1990).<sup>6</sup> In addition, the district court can direct that issues that relate to a contested involuntary bankruptcy petition be

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<sup>5</sup> In general, a legal action is one in which money damages are sought, whereas an equitable action is one in which a direction that a party act or refrain from acting in a particular fashion is sought. This question is sometimes determined by reference to whether the relief sought was historically heard by the English courts of law or the English courts of equity.

<sup>6</sup> There is some dispute as to whether the estate’s counterclaims against the creditor must relate to the claims asserted.

tried without a jury. 28 U.S.C. § 1411(b). Other than with respect to the foregoing, the Bankruptcy Code does not impair any non-bankruptcy law right to a jury trial with regard to a personal injury or wrongful death tort claim. 28 U.S.C. § 1411(a).

## E. Motion Practice, Adversary Proceedings and Contested Matters

There are three ways in which issues are generally addressed to a bankruptcy court—motion practice, contested matters or adversary proceedings—each of which have particularized procedures associated with them. Depending on the particular issue, a particular method of presentment may be required.

### 1. Motion Practice

Most issues that arise in bankruptcy proceedings are presented to the bankruptcy court via motion. In this context, a motion is a written request to the bankruptcy court for an order for relief. Although there are specific rules that govern motions for certain forms of relief, in general, the only requirements for a motion are that it should set forth the relief sought and the grounds supporting such relief. Motions are to be served on other parties in interest in the bankruptcy proceeding in accordance with the Bankruptcy Rules, local bankruptcy rules, or as ordered by the bankruptcy court. These parties in interest will have the opportunity to object to the motion. Fed. R. Bankr. P. 9013.<sup>7</sup>

A court is also permitted, pursuant to Section 105(a) of the Bankruptcy Code, to change the effective date of its orders to a date earlier than when such order is granted by the court. Such an order is known as a *nunc pro tunc* order and is typically issued when the equities favor such action. See *Constant Ltd. Partnership v. Jamesway Corp.*, 179 B.R. 33, 39 (Bankr. S.D.N.Y. 1995). Courts have applied a two-pronged test to determine whether a *nunc pro tunc* order is warranted. First, if the application for the relief requested by the order was timely made, the bankruptcy court would have granted the relief.

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<sup>7</sup> While motions are also used in contested matters (described below), this discussion focuses on the use of motions outside of the context of contested matters.

And, second, the delay in seeking the relief requested resulted from “extraordinary circumstances.” See *Schwartz v. Aquatic Dev. Group, Inc.*, 352 F.3d 671, 678 (2d Cir. 2003). Orders authorizing retention of various professionals, discussed above in Chapter III.I., are often issued on a *nunc pro tunc* basis.

## 2. *Adversary Proceedings*

Unlike motion practice and contested matters, adversary proceedings, which are governed by Part VII of the Bankruptcy Rules, resemble non-bankruptcy civil litigation and, in fact, incorporate many of the Federal Rules of Civil Procedure through the Bankruptcy Rules. Thus, for example, adversary proceedings are commenced through the filing and service of a complaint rather than a motion. Fed. R. Bankr. P. 7003–7004.

Adversary proceedings are reserved for certain specific matters of controversy which would seek to significantly and directly impact one party’s rights, including proceedings to recover money or property, to determine the validity, priority or extent of liens or other interests in property, to object to or revoke a discharge, to revoke a confirmation order, to obtain an injunction or other equitable relief outside of a plan, to subordinate an allowed claim or interest outside of a plan and to obtain a declaratory judgment relating to any matter required to be commenced by adversary proceeding. Fed. R. Bankr. P. 7001.

## 3. *Contested Matters*

Contested matters are a sort of hybrid between motion practice and adversary proceedings. On the one hand, like motion practice, the relief is presented to the bankruptcy court via motion and not complaint. On the other hand, like adversary proceedings, they involve issues as to which there is a dispute between at least two different parties and many of the Bankruptcy Rules (and, in turn, many of the Federal Rules of Civil Procedure) applicable to adversary proceedings also apply to contested matters. Fed. R. Bankr. P. 9014.

Issues that are subject to contested matters include dismissal or conversion of a bankruptcy case (Fed. R. Bankr. P. 1017(f)(1)), objections to confirmation of a plan (Fed. R. Bankr. P. 3020(b)(1)), relief from the

automatic stay (Fed. R. Bankr. P. 4001(a)), use of cash collateral (Fed. R. Bankr. P. 4001(b)), obtaining credit (Fed. R. Bankr. P. 4001(c)) and avoidance of a lien under Section 522(f) (Fed. R. Bankr. P. 4003(d)).

## F. Compromise and Settlement

Notwithstanding the different procedures for requesting relief from a bankruptcy court, there is a single process for approval of settlements of disputes in bankruptcy—the filing of a motion upon notice and hearing. This process is governed by Bankruptcy Rule 9019.

As settlements are favored in bankruptcy, the standard for approval of a settlement is rather low, requiring only a determination as to whether the proposed compromise “fall[s] below the lowest point in the range of reasonableness.” *In re Adelfia Communications Corp.*, 327 B.R. 143, 170 (Bankr. S.D.N.Y. 2005) (quoting *In re W.T. Grant & Co.*, 699 F.2d 599, 608 (2d Cir. 1983)). In reaching this decision, the bankruptcy court is not to hold a mini-trial, but is just to survey the issues and determine if the settlement is fair and equitable and in the best interests of the bankruptcy estate. *Id.*

## G. Appeals

As with other cases and proceedings in the United States judicial system, the bankruptcy system provides parties with the right to appeal adverse decisions. As a general matter, decisions by bankruptcy courts are appealed first to the district court for the district in which the bankruptcy court is located and then to the applicable circuit court and finally to the U.S. Supreme Court. 28 U.S.C. § 158. It is possible, in certain circumstances, however, to appeal an adverse decision directly from a bankruptcy court to a circuit court. 28 U.S.C. § 158(d)(2).<sup>8</sup> Furthermore, unique to the bankruptcy system is the introduction of bankruptcy appellate panels. These panels, which are typically created at the determination of each individual circuit, are comprised of bankruptcy judges and replace the district court in

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<sup>8</sup> These circumstances include questions of law for which there is not a controlling decision of the relevant Circuit Court or the U.S. Supreme Court or when an immediate appeal may materially advance the progress of the case or proceeding.

the appellate chain unless one of the parties opts to have the appeal heard by the district court instead.<sup>9</sup> 28 U.S.C. § 158(b)–(c).

The ability to appeal a particular decision depends, in part, on whether such decision is a “final” decision or an “interlocutory” decision. Final decisions may be appealed as of right, whereas interlocutory decisions may only be appealed with the consent of the district court or bankruptcy appellate panel. In short, a final decision is one that finally concludes the particular matter it addresses; an interlocutory decision is one that only determines an intervening matter and for which further steps are required before the issue can be decided on the merits. See *Yerushalmi v. Pergament*, (*In re Yerushalmi*) 2010 Bankr. LEXIS 454, at \*6 (Bankr. E.D.N.Y. Feb. 12, 2010) (citing *Burke v. Croson*, 85 N.Y. 2d 10, 15 (N.Y. 1995)).

In general, any party in a bankruptcy case whose “rights or interests are ‘directly and adversely affected pecuniarily’ by the order or decree of the bankruptcy court” has standing to appeal a decision of the bankruptcy court. See *Kane v. Johns-Manville Corp.*, 843 F.2d 636, 642 (2d Cir. 1988); see also *Moran v. LTV Steel Co.* (*In re LTV Steel Co.*), 560 F.3d 449, 452 (6th Cir. 2009).

The procedures for appeals of decisions from the bankruptcy courts are set forth in Part VIII of the Bankruptcy Rules and the procedures for appeals of decisions from the district courts and bankruptcy appellate panels are set forth in the Federal Rules of Appellate Procedure. Of particular note, however, appeals from the bankruptcy court must be filed within fourteen days from the date of entry of the judgment, order or decree appealed from. Fed. R. Bankr. P. 8002(a).

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<sup>9</sup> The First, Sixth, Eighth, Ninth and Tenth Circuits have bankruptcy appellate panels; the Second, Third, Fourth, Fifth, Seventh, and Eleventh do not.

## H. Examinations in Bankruptcy

In order for parties in interest in a bankruptcy case to be able to fully protect their rights and interests, they will often need access to information and documents in the possession of other parties. Accordingly, in addition to the rules of discovery incorporated into the Bankruptcy Rules that are applicable in adversary proceedings and contested matters, the Bankruptcy Code and Bankruptcy Rules also include certain provisions governing the ability of one party to otherwise examine another party in the context of a bankruptcy proceeding. Although certain of these provisions govern all parties in a bankruptcy, there are additional provisions which apply to only the debtor.

### 1. *Rule 2004 Examinations*

Pursuant to Bankruptcy Rule 2004, upon the motion of a party in interest, the court may order the examination of any entity (a “Rule 2004 Examination”), including, without limitation, the debtor or debtor-in-possession, creditors of the debtor and relatives of the debtor. In addition, Section 343 of the Bankruptcy Code requires the debtor to appear and submit to examination at the meeting of creditors held under Section 341 (see discussion below at Chapter III.H.2.), and the scope of this examination is governed by Rule 2004. Section 343 does not address the examination of anyone besides the debtor, and the examination of third parties is governed solely by Bankruptcy Rule 2004.

In relevant part, Bankruptcy Rule 2004(b) provides, “[t]he examination of an entity under this rule or of the debtor under § 343 of the Bankruptcy Code 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 estate, or to the debtor’s right to a discharge.” In reorganization cases, such examinations 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 to the formulation of a plan.” *Id.*

As a general matter, Rule 2004 Examinations “are appropriate for revealing the nature and extent of the bankruptcy estate and for ‘discovering assets, examining transactions, and determining whether wrongdoing has occurred.’” *In re Enron Corp.*, 281 B.R. 836, 840 (Bankr. S.D.N.Y. 2002) (internal citations omitted). The scope of such examinations is “broad and unfettered and *in the nature of fishing expeditions.*” *Id.* (emphasis added).

Obviously, however, the availability of Bankruptcy Rule 2004 is not without limitations, and courts will not allow Rule 2004 Examinations to proceed where the examination is designed to abuse or harass, where the examination seeks to obtain irrelevant information or where the examination would circumvent the stricter discovery requirements set forth in the Federal Rules of Civil Procedure. Moreover, although the scope of a Rule 2004 Examination is broad, such examination must be both pertinent and reasonable. *See, e.g., In re Countrywide Home Loans, Inc.*, 384 B.R. 373, 393-94 (Bankr. W.D.Pa. 2008).

There is a relative dearth of case law examining what it means for a Rule 2004 Examination to be designed to abuse or harass the examinee. In one case that was noteworthy for the attention it paid to this subject, the Second Circuit concluded that a party’s use of Bankruptcy Rule 2004 to “explore the subject matter of [an] already concluded adversary proceeding while the appeal on that proceeding was pending in the district court” was solely for the purpose of harassment. *Martin v. Schapp Moving Sys., Inc.*, No. 97-5042, 1998 U.S. App. LEXIS 15255 (2d Cir. 1998) (unpubl.). In another case, the Southern District of New York restricted a creditor’s attempt to use Bankruptcy Rule 2004 to obtain a massive amount of documents from an examinee, noting that the examination “should not encompass matters that will be unduly burdensome to the debtor and duplicative of previously furnished information.” *In re Texaco, Inc.*, 79 B.R. 551, 553 (Bankr. S.D.N.Y. 1987); *see also In re Country Wide Home Loans*, 384 B.R. 373 (Bankr. W.D. Pa. 2008).

Courts are particularly concerned that Bankruptcy Rule 2004 not be used as a means of navigating around the substantive and procedural protections of the Federal Rules of Civil Procedure. *See In re Enron Corp.*, 281 B.R. 836 (Bankr. S.D.N.Y. 2002) (enumerating the distinctions between a Rule 2004 examination and discovery under the Federal Rules of Civil Procedure). Most courts accept that “once an adversary proceeding or contested matter is commenced, discovery should be pursued under the Federal Rules of Civil

Procedure and not Rule 2004.” *Id.* at 840; see also *In re Drexel Burnham Lambert Group, Inc.*, 123 B.R. 702, 711 (Bankr. S.D.N.Y. 1991). However, some courts do not consider pending litigation a relevant factor in a decision to allow a Rule 2004 Examination. See *In re Analytical Sys., Inc.*, 71 B.R. 408, 413 (Bankr. N.D. Ga. 1987).

It is less evident, however, that a party’s right to the protections afforded by the Federal Rules of Civil Procedure exists *prior* to the initiation of litigation. See *In re Recoton Corp.*, 307 B.R. 751, 756 (Bankr. S.D.N.Y. 2004); *In re Mirant Corp.*, 326 B.R. 354, 356-57 (Bankr. N.D. Tex. 2005) (observing that the language of Bankruptcy Rule 2004 is “not limited to exclude instances where the litigation is, or may soon be, pending . . .”). The key distinction seems to be whether the Bankruptcy Rule 2004 examiner seeks discovery to determine whether viable claims against the examinee exist or to obtain information that it already intends to use against the examinee in a subsequent proceeding.

Similar concerns arise when courts confront situations where the party seeking a Rule 2004 Examination could benefit from such examination in litigation pending against the examinee outside of the bankruptcy court. See *In re Enron Corp.*, 281 B.R. at 842.

## 2. Meetings of Creditors

Section 341 of the Bankruptcy Code requires the U.S. Trustee to convene and preside at a meeting of creditors within a reasonable time after the date of the order for relief. 11 U.S.C. § 341(a). In a Chapter 7 liquidation or Chapter 11 reorganization case, such meeting must be held between twenty days and forty days after the date of the order for relief. Fed. R. Bankr. P. 2003(a). All creditors must be given at least twenty-one days’ notice of the Section 341 meeting. Fed. R. Bankr. P. 2002(a)(1). The purpose of the meeting is to enable the creditors to examine the debtor under oath, to elect a trustee (if appropriate) and, in a Chapter 7 case, to ensure that the debtor has a basic understanding of the effects of bankruptcy. To the extent that it would be beneficial or useful, the U.S. Trustee may also convene and preside at a meeting of any equity security holders to be held on a date fixed by the U.S. Trustee. 11 U.S.C. § 341(b); Fed. R. Bankr. P. 2003(b)(2).



The bankruptcy court is not permitted to preside at or attend any meeting held under Section 341. Additionally, on the request of a party in interest (and after notice and a hearing), the court may order that the U.S. Trustee not convene a meeting of creditors or equity holders if the debtor has filed what is commonly referred to as a “pre-packaged” bankruptcy proceeding (see discussion below at Chapter VI.E.1.). 11 U.S.C. § 341(e).

As noted above, the debtor must appear and submit to examination under oath at the Section 341 meeting of creditors. 11 U.S.C. § 343. At that time, creditors, any indenture trustee, any trustee or examiner in the case or the U.S. Trustee may examine the debtor. The fact that a debtor may not be an individual does not excuse it from appearing at the Section 341 meeting of creditors. If, for example, the debtor is a corporation, the individuals that manage the debtor and that are most knowledgeable about the debtor will typically appear and submit to examination on the debtor’s behalf. As described in the preceding subsection, examination of the debtor is limited to matters which may affect the financial condition or discharge of the debtor or the administration of the debtor’s estate. Fed. R. Bankr. P. 2004(b). Additionally, in cases commenced under Chapters 11 (except for railroad reorganizations), 12 or 13, the scope of an examination of the debtor may include any matter relevant to the case or to the formulation of a plan of reorganization, including the operation of any business, the desirability of continuance of any business, and the source of funds or property to be acquired by the debtor for purposes of consummating the plan. *See id.* The purpose of the examination of a debtor under Section 343 is “to enable creditors and the trustee to determine if assets have improperly been disposed of or concealed or if there are grounds for objection to discharge.” S. Rep. 95-989, 95 Cong. 5787, 5829 (1978).

## I. Eligibility and Compensation of Trustees and Professionals

The Bankruptcy Code contains various provisions governing the eligibility and compensation of certain parties. However, these provisions are limited to parties that play fiduciary roles in a case, such as the trustee, debtor, and official committees, and generally do not apply to professionals retained by individual or ad hoc groups of parties in interest in a bankruptcy case.<sup>10</sup> For those entities, such issues will generally be addressed by private contract between the client and the professional.<sup>11</sup>

### 1. Eligibility Requirements

#### a. The Trustee

Section 321 of the Bankruptcy Code sets forth the eligibility requirements that apply to all trustees serving in cases under the Bankruptcy Code. First, Section 321(a)(1) provides that an individual trustee must be competent to perform the duties of a trustee and, for Chapter 7, 12 and 13 cases, reside or have an office in the judicial district within which the case is pending. To be competent, a trustee must exhibit expertise and experience in the matter for which it has been appointed and hold a vast understanding of the bankruptcy process. See *In re Jack Greenberg, Inc.*, 189 B.R. 906, 909 n.6 (Bankr. E.D. Pa. 1995). In a case filed under Chapter 7, 12 or 13, a corporation may also act as a trustee if it is authorized to do so by its bylaws or charter. 11 U.S.C. § 321(a)(2). However, the trustee may not have any interest which is adverse to the estate. See *Dye v. Brown (In re AFI Holding, Inc.)*, 355 B.R. 139, 149 (9th Cir. B.A.P. 2006).

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<sup>10</sup> As discussed in Chapters I.A. and VI.A., in a Chapter 11 context, reference to a “trustee” generally also encompasses a debtor-in-possession. (A discussion of the debtor-in-possession is found below in Chapter VI.A.). However, this notion does not apply to the eligibility and compensation of a trustee discussed in this section of this Guide. In this context, reference to a “trustee” applies solely to a third party trustee appointed in a bankruptcy case. It does apply, however, when discussing the retention of professionals by a trustee.

<sup>11</sup> However, if the individual or ad hoc group seeks to have its professionals compensated by the estate, then the Bankruptcy Code and Bankruptcy Rules govern. The compensation of such professionals through Section 503(b) is discussed in Chapter III.I.2. Furthermore, in the case of ad hoc groups, Rule 2019, discussed in Chapter III.B., is also relevant.

Section 322 of the Bankruptcy Code states the requirements for qualifying as a trustee in a Chapter 7, 11, 12 or 13 case. According to Section 322(a), a trustee may be qualified in such a case by timely filing with the court a bond in favor of the United States conditioned on the faithful performance of its official duties. The amount and sufficiency of a trustee's bond is determined by the U.S. Trustee. Upon appointment of a trustee, the clerk of the court may be asked to certify that the trustee has qualified. Fed. R. Bankr. P. 2011. U.S. Trustees automatically qualify under Section 322(b) of the Bankruptcy Code and do not have to file a bond.

The trustee is the representative of the estate and has the capacity to sue and be sued. 11 U.S.C. § 323. Furthermore, a court can remove a trustee, that is not a U.S. Trustee, for cause after notice and a hearing. 11 U.S.C. § 324(a). The Bankruptcy Code does not specify grounds for removal, but, in the past, removal has been authorized where the trustee was found to be incompetent or unwilling to perform its duties, the trustee violated the fiduciary duty it owed to the estate or the trustee was guilty of official or personal misconduct. See *Livore v. Horgrave (In re Livore)*, No. 08-32423, 2010 Bankr. LEXIS 1653, at \*5 (Bankr. D. N.J. May 6, 2010); see also *In re Lumborg*, 110 B.R. 106, 108 (Bankr. D. Conn. 1990).

## b. Professionals

Section 327 of the Bankruptcy Code governs the trustee's or debtor-in-possession's employment of attorneys, accountants, appraisers, auctioneers and other professional persons. Generally, a professional must be approved by the court, may not hold or represent an interest adverse to the estate and must be "disinterested," pursuant to Section 101 of the Bankruptcy Code. 11 U.S.C. § 327(a). According to Section 101(14), in order to be disinterested, a person (i) may not be a creditor, equity security holder, or an insider of the debtor, (ii) may not have been a director, officer, or employee of the debtor within the two years before the filing of the case, and (iii) may not have an interest materially adverse to the interest of the estate or any class of creditors or equity security holders.

The Bankruptcy Code provides three important exceptions to the disinterestedness requirements discussed above. First, a trustee may, with the court's approval, employ an attorney that has represented the debtor if such employment is for a "specified special purpose," other than representing the

trustee in conducting the case, and if such attorney does not hold any interest adverse to the debtor or the estate with respect to the matter on which such attorney is to be employed. 11 U.S.C. § 327(e). Second, according to Section 327(c), a person is not disqualified from employment by the trustee in a case filed under Chapters 7, 11 or 12 solely due to such person's employment by or representation of a creditor. Third, a person is not disqualified from representing a debtor-in-possession solely because it was employed by or represented the debtor prior to the commencement of the case. 11 U.S.C. § 1107(b).

If the trustee requests the employment of a professional under Section 327, Bankruptcy Rule 2014(a) requires that the trustee file with the court an application that specifies the facts demonstrating the necessity for the employment, the name of the person or entity to be employed, the professional services to be rendered, and the arrangement for compensation. The retention application must also be served upon the U.S. Trustee. A professional that fails to obtain court approval prior to employment may forfeit the right to compensation. *See In re Integrity Supply, Inc.*, 417 B.R. 514, 518–19 (Bankr. S.D. Ohio 2009). However, this can be avoided in certain circumstances, as bankruptcy courts are empowered to grant *nunc pro tunc* retention orders, discussed in greater detail in Chapter III.E.1. above. An attorney representing a debtor-in-possession must also obtain court approval prior to its retention, but an attorney need not obtain court approval when representing a debtor in a liquidation case under Chapter 7, in a Chapter 13 case, or pursuant to its representation of a debtor that is not in-possession in a Chapter 11 case. *In re Designaire Modular Home Corp.*, 517 F.2d 1015 (3d Cir. 1975).

In addition to the professionals retained pursuant to Section 327 discussed above, the trustee may seek to continue to employ (i) so-called “ordinary course professionals” or (ii) professionals who are not considered “professional persons” within the meaning of Section 327 because they do not play an intimate role in the reorganization of the estate. *See In re Johns-Manville Corp.*, 60 B.R. 612, 620–21 (Bankr. S.D.N.Y. 1986). Ordinary course professionals are typically professionals who are assisting the trustee with one or a few specific, segregated matters, such as a particular litigation, transaction or regulatory regime, and whose monthly fees for such work are within certain preapproved monthly maximum amounts.

The trustee typically will seek authorization to employ and compensate ordinary course professionals pursuant to Sections 327(e), 328, 363(c)(1) and 1108 of the Bankruptcy Code. However, given their limited role and cost, the retention and compensation procedures for such professionals are often more streamlined and less burdensome than for professionals who are playing a much larger role for the debtor. Furthermore, courts have held that other parties do not fall within the scope of “professional persons” to be retained under Section 327(a), and thus do not require prior court approval under Section 327(a). Such parties include, but are not limited to: environmental consultants, property managers, lobbyists, unlicensed brokers, and expert witnesses.

As discussed below in more detail in Chapter VI.D., Section 1102 of the Bankruptcy Code contemplates the appointment of various “official” committees in a bankruptcy case. Section 1103(a) permits such an official committee to retain attorneys, accountants or other agents to represent or perform services for the committee. However, the committee’s selection and authorization is subject to the court’s approval, and may only be done at a scheduled meeting of the committee at which a majority of its members are present. 11 U.S.C. § 1103(a). The committee’s professionals are also subject to certain disinterestedness rules. An attorney or accountant that represents a creditors’ committee may not represent any other entity having an interest adverse to the debtor or the estate. 11 U.S.C. § 1103(b). However, an attorney or accountant that represents a creditors’ committee may represent multiple creditors within the same class. *Id.*

## 2. Compensation

In addition to governing the ability of trustees, debtors-in-possession and official committees to retain professionals, the Bankruptcy Code also sets forth certain requirements for the compensation of trustees and such professionals. The allowance of and limitations on trustee compensation and reimbursement of expenses are governed by Sections 326, 330 and 331 of the Bankruptcy Code, whereas the allowance of and limitations on other professionals’ compensation and reimbursement of expenses are governed by Sections 328 and 330 of the Bankruptcy Code.

In Chapter 7 and 11 cases, the trustee's compensation is based on a percentage of the distributions it makes to parties in interest other than the debtor. 11 U.S.C. § 326(a). This percentage is a cap, and a court may grant an amount less than the cap. According to Section 326, as the amount of distributions increases in a case, the percentage payable to the trustee decreases. However, in cases where the trustee has performed considerable services for the estate but has not disbursed any funds, certain courts have allowed the trustee to be compensated in a reasonable manner for such services. *See, e.g., In re Heatherly*, 179 B.R. 872 (Bankr. W.D. Tenn. 1995).

In Chapter 12 and 13 cases, the court cannot allow compensation for services or reimbursement of expenses of the U.S. Trustee or a standing trustee appointed under 28 U.S.C. § 586(b), but may allow reasonable compensation under Section 330 of the Bankruptcy Code for a trustee appointed under Section 1202(a) or 1302(a). Such compensation may be paid to the trustee after the trustee renders its services and cannot exceed five percent of all payments under a plan of reorganization. 11 U.S.C. § 326(b). If a "standing" trustee is appointed in a Chapter 12 or 13 case, the compensation paid to such trustee is governed by 28 U.S.C. § 586.

Section 328(a) of the Bankruptcy Code, which applies to professionals, requires that the terms and conditions of the engagement be reasonable. In particular, this Section permits the use of retainers and hourly, fixed or percentage and contingent fee arrangements. The court, however, may modify the terms and conditions governing compensation of the professional after the conclusion of the employment should the previously approved compensation agreement subsequently prove to be improvident in light of unexpected developments. 11 U.S.C. § 328(a). Moreover, if at any point during the pendency of the case, the court finds that a professional person is not a disinterested person, the court may deny allowance of compensation and reimbursement of expenses for such person. 11 U.S.C. § 328(c).

Section 329 of the Bankruptcy Code provides certain rules regarding a debtor's transactions with its attorneys. According to Section 329, an attorney representing the estate in connection with its bankruptcy must file with the court a statement of the compensation agreed to be paid to it and the source of such compensation, if such payment or agreement was made within one year before the petition date. Moreover, a court may cancel any agreement or order the return of any payment to the extent such compensation exceeds the "reasonable value" of any services the attorney has rendered. *See* 11

U.S.C. § 329(b). A court may order the return of any such payment to (i) the estate if the property transferred would have been property of the estate or was to be paid by or on behalf of the debtor under a plan under Chapter 11, 12 or 13 or to (ii) the entity that made the payment.

Section 330 of the Bankruptcy Code also establishes limitations on the compensation allowable to trustees as well as officers of the estate and professionals employed under Section 327 or 1103 of the Bankruptcy Code. Sections 330(a)(1)(A) and (a)(1)(B) provide that after notice has been given to all parties in interest and to the U.S. Trustee, and after a hearing has been held, the court may award a trustee, examiner, ombudsman, or professional person (including an attorney, accountant or financial advisor) *reasonable* compensation for the actual and necessary services rendered by it and may reimburse such entity for its actual and necessary expenses. In determining the amount of reasonable compensation payable to such entity, the court may take into account all relevant factors, including the time spent on such services, the rates charged for such services, whether the services were necessary and beneficial to the administration of the estate, whether the services were performed within a reasonable amount of time, whether the person that performed the services is board certified or otherwise experienced in the bankruptcy field, and whether the compensation is reasonable, based on the customary compensation charged by comparably skilled practitioners in nonbankruptcy cases.<sup>12</sup> 11 U.S.C. § 330(a)(3).

A trustee or professional may seek interim payments of its compensation pursuant to Section 331 of the Bankruptcy Code. Bankruptcy courts often authorize detailed procedures to govern the payment of interim compensation during a bankruptcy case as part of their local rules. Moreover, courts will reduce the amount of compensation awarded pursuant to Section 330 by the amount of any interim compensation awarded under Section 331. 11 U.S.C. § 330(a)(5).

The Bankruptcy Code also provides various methods by which the bankruptcy estate is permitted to compensate and reimburse professionals employed by parties other than the debtor-in-possession, trustee, or an official committee. In particular, Section 503(b) of the Bankruptcy Code provides

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<sup>12</sup> Courts have also adopted a set of factors first noted in *Johnson v. Georgia Highway Express, Inc.*, 488 F.2d 714 (5th Cir. 1974), where the court considered twelve factors to be relevant to a determination of reasonableness of attorney's fees.

for the allowance, as an administrative expense, of the actual and necessary expenses of a creditor, including reasonable compensation for professional services rendered by a creditor's attorney, where a "substantial contribution" to a Chapter 11 case has been made. 11 U.S.C. § 503(b)(3)(D)–(b)(4); *see also* *Lebron v. Mechem Fin., Inc.*, 27 F.3d 937, 943 (3d Cir. 1994). The reimbursement of fees and expenses pursuant to Sections 503(b)(3)(D) and 503(b)(4) of the Bankruptcy Code is designed to encourage meaningful participation by creditors and other parties-in-interest in a debtor's reorganization. *See id.* Although the Bankruptcy Code does not define the term "substantial contribution," courts have generally looked to determine whether the actions of the party seeking reimbursement pursuant to Sections 503(b)(3)(D) and 503(b)(4) have rendered an actual and demonstrable benefit to the debtor's estate and its creditors generally. *Id.* at 943–44.



# IV

COMMENCEMENT OF BANKRUPTCY CASES



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## IV. Commencement of Bankruptcy Cases

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### A. Who May Be A Debtor

#### 1. Generally

Only a person that resides or has a domicile, a place of business or property in the United States may be a debtor under the Bankruptcy Code. “Person” is defined to include an “individual, partnership and corporation” but excludes governmental units, with certain limited exceptions. 11 U.S.C. § 101(41). (Governmental units include the United States, individual states, commonwealths and districts as well as departments, agencies and instrumentalities of the United States.)

Any person may file for bankruptcy under Chapter 7, provided that it is not a railroad, an insurance company, a small business investment company licensed by the Small Business Administration or certain banking institutions.<sup>13</sup> Only a person that is eligible for liquidation under Chapter 7 and a railroad may be a debtor under Chapter 11. Stockbrokers and commodity brokers, however, are excluded from Chapter 11 and may only file for bankruptcy under Chapter 7. 11 U.S.C. § 109(b), (d).

Only a municipality that (i) is unable to pay its debts as they come due, (ii) is specifically authorized by State law to be a debtor under Chapter 9, and (iii) intends to effect a plan to adjust its debts may proceed under Chapter 9. “Municipality” is defined to mean a “political subdivision or public agency or instrumentality of a State.” 11 U.S.C. § 101(40).

An individual with regular income, or an individual with regular income and his or her spouse, may file for bankruptcy under Chapter 13 so long as such individual owes (i) noncontingent, liquidated, unsecured debts in the amount of \$360,475 or less and (ii) noncontingent, liquidated, secured debts in the amount of \$1,081,400 or less. 11 U.S.C. § 109(e).

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<sup>13</sup> Insurance companies and banks are generally excluded from eligibility because their liquidation and rehabilitation are governed by various regulatory schemes.

## 2. Means Testing

Although individuals are, as a general matter, eligible to file for bankruptcy under various Chapters of the Bankruptcy Code, whether an individual debtor will be eligible for Chapter 7 or instead will be required to proceed under Chapter 13 (and, if so, the terms of its Chapter 13 proceeding) is determined by reference to such individual's financial situation or "means." These so-called "means tests" were included as part of the 2005 Amendments and are intended to prevent individuals above certain income levels from using bankruptcy to disadvantage their creditors.

### a. Chapter 7 Means Test

The Chapter 7 means test is a threshold inquiry that determines whether an individual debtor with primarily consumer debts is eligible to file for bankruptcy under Chapter 7, which, generally speaking, benefits the debtor by allowing him or her a full discharge of his or her unsecured debts (with certain exceptions).<sup>14</sup> If a debtor fails this means test (*i.e.*, he or she is found to have sufficient financial means to pay at least a portion of his or her debts), then he or she will be deemed ineligible for Chapter 7, forcing the debtor into Chapter 13.

Section 707(b) of the Bankruptcy Code provides that the court, on its motion or on a motion by the U.S. Trustee, private trustee or any party in interest, may dismiss a case filed by an individual debtor whose debts are primarily consumer debts or, with the debtor's consent, convert such a case to Chapter 11 or 13, if the court finds that granting such debtor relief under Chapter 7 would constitute an abuse of the provisions of Chapter 7. 11 U.S.C. § 707(b)(1). Two kinds of "safe harbors" exist with respect to the Chapter 7 means test. In general, these safe harbors limit who may file a Section 707(b) motion to dismiss or convert the debtor's case. First, only a judge or the U.S. Trustee may file a Section 707(b) motion if the current monthly income of (i) the debtor or (ii) in a joint case, the debtor and his or

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<sup>14</sup> Generally speaking, a Chapter 13 debtor enjoys an absolute right to convert to Chapter 7. If, however, he or she fails the Chapter 7 means test, he or she will not be permitted to convert his or her case to Chapter 7.

her spouse is equal to or less than the applicable State median family income for a family of equal or lesser size. Second, no one can file a Section 707(b) motion if the current monthly income of the debtor and his or her spouse combined (whether in a joint case or otherwise) is equal to or less than the applicable State median family income for a family of equal or lesser size.

The court may presume the existence of an abuse of the provisions of Chapter 7 if the debtor's current monthly income reduced by certain amounts discussed below and multiplied by sixty, is not less than the lesser of (i) 25% of the debtor's nonpriority unsecured claims in the case, or \$6000, whichever is greater or (ii) \$10,000. 11 U.S.C. § 707(b)(2)(A)(i). The presumption of abuse can only be rebutted by demonstrating "special circumstances." 11 U.S.C. § 707(b)(2)(B)(i). Although the Bankruptcy Code does not define "special circumstances," Section 707(b) provides two examples: a serious medical condition or a call or order to active duty in the Armed Forces.

In determining the debtor's current monthly income, the court shall reduce such income by the following amounts: (i) the applicable monthly expenses of the debtor and his or her spouse and dependents specified under the Internal Revenue Service's National Standards and Local Standards; (ii) the actual monthly expenses of the debtor and his or her spouse and dependents for the categories specified as Other Necessary Expenses by the Internal Revenue Service; (iii) reasonably necessary expenses incurred to maintain the safety of the debtor and his or her family from family violence as specified in applicable Federal law; (iv) reasonably necessary expenses for health and disability insurance for the debtor and his or her spouse and dependents; and (v) the debtor's average monthly payments on account of secured debts and priority claims. 11 U.S.C. § 707(b)(2)(A). The court may also reduce the debtor's current monthly income by the following amounts: (i) the continuation of actual expenses paid by the debtor that are reasonable and necessary for the care and support of members of the debtor's immediate family who are unable to pay for such expenses; (ii) for a debtor that is eligible for Chapter 13, the actual administrative expenses of administering a Chapter 13 plan (up to an amount of 10% of the projected plan payments); (iii) certain educational expenses for a debtor's dependent children; and (iv) additional allowances for housing, utilities, food and clothing. *Id.*

## b. Chapter 13 Means Test

In Chapter 13, a means test is used to determine the length of the debtor’s plan and the amount of payments to unsecured creditors under such plan. If the current monthly income of the debtor and his or her spouse combined is less than the applicable State median family income for a family of equal or lesser size, a debtor’s Chapter 13 plan may not provide for payments over a period of time that is longer than three years, unless the court, for cause, approves a longer period (although the court cannot approve a period that is longer than five years). 11 U.S.C. § 1322(d)(2). If the current monthly income of the debtor and his or her spouse combined is greater than the applicable State median family income for a family of equal or lesser size, a debtor’s Chapter 13 plan may not provide for payments over a period of time that is longer than five years. 11 U.S.C. § 1322(d)(1).

The means test also informs the amount of payments to unsecured creditors under a Chapter 13 debtor’s plan. Section 1325(b)(1) permits an inquiry into whether the debtor is paying enough under his or her plan, however, such inquiry may be made only upon the filing of a confirmation objection by the Chapter 13 trustee or an unsecured creditor. Once such an objection is filed, if the value of the property to be distributed under the plan on account of such claim is less than the amount of such claim, then the court must consider whether the full amount of the debtor’s projected disposable income to be received during the length of the plan period will be applied to make payments to unsecured creditors under the plan. 11 U.S.C. § 1325(b)(1). For purposes of the foregoing provisions, “disposable income” is defined to mean current monthly income received by the debtor (with certain exceptions)<sup>15</sup> less the amounts reasonably necessary to be expended for the maintenance or support of the debtor or one of the debtor’s dependents, charitable contributions to qualified institutions, and, to the extent the debtor is engaged in business, amounts for the payment of expenditures necessary for the continuation, preservation and operation of such business. 11 U.S.C. § 1325(b)(2). If the debtor’s current monthly income exceeds the applicable State median income for his or her household size, then the “amounts

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<sup>15</sup> These exceptions include child support payments, foster care payments or disability payments for a dependent child.

reasonably necessary to be expended” under Section 1325(b)(2) must be determined in accordance with subparagraphs (A) and (B) of Section 707(b)(2) (see discussion above). If the debtor’s current monthly income is below the applicable State median income for his or her household size, the calculation of his or her expenses will largely be determined by the court’s judgment of whether such expenses are reasonable.

### 3. *Insolvency*

Although, as discussed above, eligibility for relief under the Bankruptcy Code is limited by type of entity, except in Chapter 9, an otherwise eligible entity need not be insolvent in order to qualify for bankruptcy protection.<sup>16</sup>

Notwithstanding this, the concept of insolvency does play a role in various contexts in a bankruptcy proceeding. Under Section 101(32) of the Bankruptcy Code, insolvency is defined by reference to a debtor’s assets and liabilities and is sometimes referred to as a “modified” balance sheet test because it refers to the items contained in a balance sheet, yet does not follow Generally Accepted Accounting Principles when valuing such items. Furthermore, the test for insolvency differs depending on the type of entity at issue.

For all entities other than partnerships and municipalities, an entity is insolvent when the sum of its debts is greater than the value of its property, taken at a “fair valuation.” 11 U.S.C. § 101(32)(A). For purposes of this test, property transferred, concealed or removed with the intent to hinder, delay or defraud creditors and property exempted under Section 522 of the Bankruptcy Code are excluded from the calculation. *Id.* Although different courts have developed somewhat different tests for determining “fair valuation,” in general it means the market value of an asset sold in a prudent fashion over a reasonable (neither too long nor too short) period of time. *In re Durso Supermarkets*, 193 B.R. 682, 701 (Bankr. S.D.N.Y. 1996).

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<sup>16</sup> As will be discussed below in Chapter IV.B.2., in the context of an involuntary bankruptcy filing, the petitioning creditor(s) must demonstrate that the alleged debtor is generally not paying its debts as they become due. Although this test is not included in the definition of “insolvent” under the Bankruptcy Code (except when referring to municipalities), bankruptcy practitioners often colloquially refer to this test as a test of insolvency. The same is also true for the undercapitalization test that appears in the context of fraudulent conveyances.

For partnerships, the test is similar, but does not exclude exempted property under Section 522 and also takes into account the excess value of each general partner's nonpartnership property (exclusive of concealed property and exempt property) over such general partner's nonpartnership debts. 11 U.S.C. § 101(32)(B). Municipalities, on the other hand, are determined to be insolvent based not on their balance sheets, but instead on whether or not they are paying (or are able to pay) their debts as they become due. 11 U.S.C. § 101(32)(C).

## B. Type of Filing

### 1. *Voluntary Filing*

A voluntary bankruptcy case is commenced when the debtor files a petition under the particular Chapter of the Bankruptcy Code under which it wishes to proceed. The filing of the petition triggers the automatic stay (discussed below in Chapter V.B.) and constitutes the order for relief under the Chapter under which the petition is filed. 11 U.S.C. §§ 301, 362(a). Entry of such order for relief, however, is not a binding determination of either a debtor's eligibility to be a debtor under the Bankruptcy Code or any other substantive matter.

A husband and wife may commence a voluntary joint case by filing a single petition under an appropriate Chapter of the Bankruptcy Code. 11 U.S.C. § 302. For a joint filing, both spouses must agree to the filing; neither spouse can file without the knowledge and consent of the other. Joint administration is primarily administrative in nature. After a joint case has been commenced, the court determines the extent, if any, to which the debtors' estates shall be substantively consolidated (*i.e.*, their individual assets and liabilities will be combined into a single pool out of which creditors will be paid) based on a consideration of certain factors, including whether there is a substantial identity between assets, liabilities and the handling of financial affairs, and whether any harm may result from granting or denying the motion.<sup>17</sup>

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<sup>17</sup> Substantive consolidation is discussed in greater detail in Chapter V.B.2. below.



## 2. Involuntary Filing

An involuntary bankruptcy case may be commenced only under Chapter 7 or 11 and only against a person that is eligible to be a debtor under the selected Chapter, unless the person is a farmer or a corporation that is not a business or commercial corporation. If a debtor has twelve or more creditors, an involuntary case is commenced by the filing of a petition by three or more entities holding noncontingent, undisputed claims against the debtor, provided that such claims aggregate \$14,425 more than the value of any lien or property of the debtor that secures such claims. In the event that a debtor has fewer than twelve creditors (excluding employees or insiders of the debtor or transferees of avoidable transfers), however, the involuntary petition may be brought by one or more entities holding noncontingent, undisputed claims against the debtor provided that such claims aggregate \$14,425 above the value of the collateral. 11 U.S.C. § 303(b). The filing of an involuntary petition also triggers the automatic stay (discussed below in Chapter V.C.). 11 U.S.C. § 362(a).

If the involuntary petition is not timely challenged, the bankruptcy court orders relief under the appropriate Chapter. If the debtor files an answer, a trial is held, and relief is ordered against a debtor in an involuntary proceeding only if (i) the debtor is generally not paying its debts as such debts become due (and such debts are not the subject of a bona fide dispute as to liability or amount) or (ii) within 120 days before the filing of the petition, a custodian, other than a trustee, receiver or agent authorized to take control of less than substantially all of the debtor's property for the purpose of enforcing a lien against such property, was appointed or took possession. 11 U.S.C. § 303(h). To determine if a debtor is "generally not paying" its debts, courts apply a "totality of circumstances" test that considers a number of factors, including (i) the number of unpaid claims, (ii) the amounts of the unpaid claims, (iii) the materiality of the non-payments, and (iv) the debtor's overall financial condition. See *In re Amanat*, 321 B.R. 30, 39 (Bankr. S.D.N.Y. 2005).

## C. Procedural Matters

### 1. *Bankruptcy Petition*

As described above, a bankruptcy case, whether voluntary or involuntary, is commenced by the filing of a petition with the clerk of the bankruptcy court. The date on which the petition is filed is commonly referred to as the “petition date,”<sup>18</sup> and the time periods preceding and following the petition date are often described as the “prepetition” period and the “postpetition” period, respectively. Another term that is often used in the bankruptcy context is “date of the order for relief.”<sup>19</sup> This phrase refers generally to the date on which the bankruptcy case is deemed legally effective. In a voluntary case, use of the terms “petition date” and “date of the order for relief” refer to the same date; as stated above, the filing of a voluntary petition constitutes the order for relief under the Chapter under which the petition is filed. In an involuntary bankruptcy case, however, the order for relief will only be entered if (and when) (i) the debtor consents to or does not timely challenge the filing of the petition or (ii) following a trial, the court finds that there are sufficient grounds to sustain the petition. Accordingly, there will be a delay between the petition date and the date of the order for relief in an involuntary case (this is sometimes referred to as the “gap period”).

It is important to distinguish between the petition date and the date of the order for relief because certain provisions of the Bankruptcy Code are keyed to the former, whereas others are keyed to the latter. For example, the filing of the petition triggers the automatic stay under Section 362, creates the bankruptcy estate under Section 541 and fixes the date as of which the trustee has the rights and powers of a hypothetical judicial lien creditor or bona fide purchaser under Section 544. On the other hand, entry of the order for relief, for example, marks the beginning of the two-year period for bringing certain causes of action and the commencement of the debtor’s exclusivity periods in Chapter 11.

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<sup>18</sup> The phrase “commencement of the case” is another way of referring to the petition date.

<sup>19</sup> As per the Bankruptcy Code’s rules of construction, “order for relief” means entry of an order for relief. 11 U.S.C. § 102(6). If the court orders relief orally, but does not enter a written order until a later time, any time periods under the Bankruptcy Code, Bankruptcy Rules and local bankruptcy rules are measured from the time of entry of the written order, not from the time of the oral order.

A bankruptcy petition is a straightforward form that sets forth standard information such as the debtor's name and address, the estimated number of creditors and the estimated amounts of the debtor's assets and liabilities. Upon filing a voluntary petition under Chapter 11 or, in an involuntary Chapter 11 case, upon entry of the order for relief, the debtor becomes known as a "debtor-in-possession" (discussed below in Chapter VI.A.). The debtor will continue as a "debtor-in-possession" for the duration of the Chapter 11 case unless and until a trustee is appointed. 11 U.S.C. § 1101(1). A debtor-in-possession enjoys the rights and powers of a Chapter 11 trustee, and references to a Chapter 11 trustee are interpreted to include a debtor-in-possession (with certain limited exceptions). 11 U.S.C. § 1107(a).

## 2. *Schedules and Statements*

In every voluntary case, the debtor must file with the petition schedules of its (i) secured, unsecured priority and unsecured nonpriority creditors, (ii) executory contracts and unexpired leases, and (iii) codebtors. If the debtor is a corporation, it must also file with the petition a corporate ownership statement that identifies any corporation that owns, directly or indirectly, 10% or more of any of the classes of the debtor's equity interests. 11 U.S.C. § 521(a). In an involuntary case, the debtor has fourteen days after entry of the order for relief in which to file the above-referenced schedules. In a Chapter 11 reorganization case, the debtor must file, within fourteen days after entry of the order for relief, a list of the debtor's equity security holders of each class, showing the number and kind of interests registered to such holders. A debtor may obtain an extension of time for the filing of the schedules described above only on motion for cause shown and on notice to the U.S. Trustee and any other party as the court may direct. Fed. R. Bankr. P. 1007(a).

In addition to the list of creditors, a debtor in a voluntary Chapter 11 reorganization case or a municipality in a Chapter 9 case must file with its petition a list setting forth the name, address and claim of its twenty largest unsecured creditors (excluding insiders). A debtor in an involuntary Chapter 11 reorganization case must file such a list within two days after entry of the order for relief. Fed. R. Bankr. P. 1007(d). The purpose of such a list is to enable the U.S. Trustee to solicit creditors in connection with the formation of an official committee of unsecured creditors.

Unless the court orders otherwise, all debtors except municipalities in Chapter 9 cases are required to file (i) schedules of assets and liabilities, (ii) a schedule of current income and expenditures, (iii) a schedule of executory contracts and unexpired leases, and (iv) a statement of financial affairs. Fed. R. Bankr. P. 1007(b)(1).<sup>20</sup> These schedules and statements must be filed within fourteen days after the filing of a petition in a voluntary case or entry of the order for relief in an involuntary case. An extension of time in which to file the schedules and statements may be granted only on motion for cause shown and on notice to the U.S. Trustee and any other party as the court may direct. Fed. R. Bankr. P. 1007(c).

The debtor should pay careful attention to the instructions for each of the official forms for the schedules and statements. Failure to comply with the Bankruptcy Code and the Bankruptcy Rules can adversely affect the discharge received by the debtor later in the case. For example, if a debtor fails to list a creditor in its schedules of liabilities, such creditor's debt will most likely not be discharged and will likely survive the bankruptcy. The schedules and statements are also important because they ensure that creditors receive notice of the bankruptcy. The lists and schedules containing creditors' names and addresses are used in serving the notice of commencement of a case under the Bankruptcy Code. The schedules further enable creditors to check the accuracy of their respective claims as described by the debtor. To the extent that a creditor's claim is properly scheduled in a Chapter 11 case (*i.e.*, the amount is set forth correctly, and the claim is not listed as contingent, unliquidated or disputed), such creditor does not need to file a proof of claim against the debtor. 11 U.S.C. § 1111(a).

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<sup>20</sup> If the debtor is an individual, there are additional filing requirements.



ADMINISTRATION OF THE BANKRUPTCY CASE



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## V. Administration of the Bankruptcy Case

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### A. Estate Fiduciaries – Debtors-in-Possession and Trustees

The type and status of a particular bankruptcy proceeding will determine who is in control of a debtor and its operations once it has filed for bankruptcy as well as who administers the bankruptcy case itself. As a general matter, there are two options—either an independently appointed Chapter 7 or Chapter 11 trustee or a so-called “debtor-in-possession.”<sup>21</sup> Although many of the provisions of the Bankruptcy Code refer solely to a “trustee” when delineating who is authorized to act (or forego from acting) under a particular provision of the Bankruptcy Code (*see, e.g.*, 11 U.S.C. §§ 363(b)(1), 364(c), 365(a)), pursuant to Section 1107(a) of the Bankruptcy Code, such references to a trustee also encompass a debtor-in-possession and should be read accordingly. For purposes of this guide, references to a “trustee” also include a debtor-in-possession.

### B. Debtor’s Estate

#### 1. *Property of the Estate*

Upon commencement of a bankruptcy case, a bankruptcy estate is created. 11 U.S.C. § 541(a). This estate is a legal entity separate from the debtor and generally will receive only those interests in property that the debtor holds. Thus, when the debtor holds only legal title to property, the estate acquires only the legal interest in the property and not an equitable or beneficial interest. 11 U.S.C. § 541(d). These interests are referred to as “property of the estate.”

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<sup>21</sup> See Chapters VII.B. and VI.B. below for a discussion of Chapter 7 and 11 trustees, respectively, and Chapter VI.A. for a discussion of debtors-in-possession. Further, as discussed in Chapter VI.A., in a Chapter 11 case, the debtor will act as the debtor-in-possession unless and until a trustee is appointed. 11 U.S.C. § 1101(1). Therefore, in a case filed under Chapter 11 of the Bankruptcy Code, a debtor-in-possession will have substantially the same rights and powers as a trustee unless and until a trustee is appointed. 11 U.S.C. § 1107(a).

Property of the estate is protected from the ongoing reach of creditors by the automatic stay, which is discussed below at Chapter V.C. Moreover, it is such property that will be distributed to creditors and equity holders on account of their claims against or interests in the debtor. Property that is not included in the estate is not subject to the protections of the Bankruptcy Code, and creditors of the estate can continue to pursue such property to satisfy their claims.

Section 541(a) of the Bankruptcy Code defines property of the estate in the broadest possible sense as all legal or equitable interests of the debtor in property as of the commencement of the case, wherever located and by whomever held. This provision includes real and personal property, tangible and intangible property, and property that may not be in the debtor's possession at the commencement of the case.

According to Section 541(a), property of the estate includes:

- (i) community property belonging to both the debtor and his or her spouse in community property states;
- (ii) property recovered by the bankruptcy trustee pursuant to certain avoidance powers;
- (iii) liens transferred to the estate by the bankruptcy court;
- (iv) certain property interests acquired by the debtor within 180 days after the commencement of the bankruptcy case;
- (v) proceeds, profits, rents, or offspring from property of the estate; and
- (vi) any property interest discussed above that the estate acquires after commencement of the case.

Notwithstanding the broad scope of property of the estate, it is not without boundary. Pursuant to Section 541(b) of the Bankruptcy Code, property of the estate does not include:

- (i) a power held by the debtor that may be exercised solely for the benefit of another entity, such as that of a trustee of a trust fund;



- (ii) any interest of the debtor as lessee under a lease of nonresidential real property after the expiration of the lease term;
- (iii) the debtor's eligibility to participate in Higher Education Act programs or accreditation or licensure status as an educational institution;
- (iv) certain interests in liquid or gaseous hydrocarbons;
- (v) any amounts withheld by an employer from wages for payments as contributions to certain employee benefit plans, deferred compensation plans, tax-deferred annuities, or health insurance plans;
- (vi) any interest of the debtor in property where the debtor pledged or sold tangible personal property as collateral for a loan or advance of money (a) where the tangible personal property is in the possession of the pledgee or transferee, (b) the debtor has no obligation to repay the money or buy back the property at a stipulated price, and (c) the debtor has not exercised any right to redeem; and
- (vii) certain cash or equivalent proceeds from the sale of a money order made within fourteen days prior to the commencement of the case if the proceeds are required to be segregated from the debtor's other property.

The debtor's interest in property will become property of the estate regardless of any contractual provisions that seek to limit or prevent property that would otherwise be included in the estate from becoming property of the estate. 11 U.S.C. § 541(c)(1). However, restrictions placed on a trust, such as spendthrift provisions, will be fully enforced in bankruptcy. 11 U.S.C. § 541(c)(2).

## 2. *Substantive Consolidation*

Although estates generally are delineated on a debtor-by-debtor basis, there are situations where a court may instead consolidate the assets and liabilities of different legal entities and deal with such entities as if the assets were held and the liabilities were owed by a single entity. This is referred to as “substantive consolidation.”<sup>22</sup> Substantive consolidation merges the assets and liabilities of multiple debtor entities into a single debtor estate to which all holders of allowed claims against the merged entities are required to look for distribution, and results in all unsecured creditors of the consolidated debtors receiving the same percentage distributions. This can alter the distributions to be received by such creditors as compared to what they would have received in the absence of substantive consolidation.<sup>23</sup> For instance, if one debtor entity has a higher percentage of assets to liabilities than another related debtor entity,<sup>24</sup> substantive consolidation will cause creditors of the former entity to receive a smaller distribution than they would have without consolidation and creditors of the latter entity to receive relatively more than they would have received in the absence of such consolidation. Furthermore, substantive consolidation eliminates the presence of multiple unsecured claims against corporate affiliates, so creditors will hold only one claim against the entire group (essentially negating the impact of any guarantees).

Although there is no express statutory basis for substantive consolidation, courts applying this doctrine have derived their authority from their general equitable powers under Section 105(a) of the Bankruptcy Code. However, because of the dramatic alteration of creditors’ rights and expectations that results from substantive consolidation, courts have uniformly held that it is to be used sparingly.

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<sup>22</sup> This differs from joint administration, which is merely a procedural accommodation when multiple related debtors are involved. For a complete discussion of joint administration, see Chapter IV.B.1.

<sup>23</sup> Substantive consolidation only affects the rights of unsecured creditors and, in some instances, equity holders. Secured creditors are not affected.

<sup>24</sup> Although substantive consolidation is typically applied in situations involving related entities that are both debtors in bankruptcy, it has been applied less commonly in situations involving unrelated entities as well as situations involving a debtor and a non-debtor.

Although different Circuits have developed varying tests for substantive consolidation, as a general matter, the tests focus on two main criteria—creditor expectations and a lack of corporate formalities. For example, the Third Circuit has ruled that to approve a request for substantive consolidation, a court must find that (i) prepetition, the entities proposed to be consolidated “disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity,” or (ii) after the petition date, “their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.” *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005).

## C. Automatic Stay

### 1. *General Protections and Limitations*

Immediately upon the filing of a petition under any Chapter of the Bankruptcy Code, an umbrella of protection, known as the automatic stay, opens over the debtor and its property. The automatic stay, the most fundamental of all protections afforded by the Bankruptcy Code, acts to protect the debtor and property of the estate from all types of collection efforts and to provide the debtor with relief from the financial and, in some cases, emotional pressures that led to the bankruptcy filing. With the imposition of the automatic stay, the debtor is granted time to reorganize and restructure its debts or, under a liquidation, ensure that its assets are distributed to creditors in an orderly fashion. Furthermore, because the imposition of the stay is automatic, it applies to all creditors, regardless of their knowledge of the filing of the petition.

The automatic stay applies only to property of the estate, and, therefore, actions against property that is not property of the estate are not stayed by the automatic stay. 11 U.S.C. § 362(c)(1). Similarly, the automatic stay terminates when a case is closed, a petition is dismissed, or the debtor’s discharge is denied or granted by the court. 11 U.S.C. § 362(c)(2). A party may also seek to modify or terminate the stay, which is addressed in the discussion of Section 362(d) of the Bankruptcy Code in Chapter V.C.3. below. Finally, the automatic stay can be terminated if an individual files repeat bankruptcy cases in close succession. 11 U.S.C. § 362(c)(3)–(4).

## 2. *Specific Protections and Limitations*

Section 362(a) of the Bankruptcy Code provides for eight categories of collection activities that are automatically stayed upon the filing of a bankruptcy petition. These activities are:

- (i) the commencement or continuation of any proceeding against the debtor that was or could have been commenced before the bankruptcy filing or to recover a claim against the debtor that arose prepetition;
- (ii) the execution and levy against the debtor or its property of a prepetition judgment;
- (iii) any action designed to obtain possession of or exercise control over property of the estate;
- (iv) the creation, perfection or enforcement of liens against property of the estate;
- (v) the creation, perfection or enforcement of liens against property of the debtor to the extent that such liens secure a prepetition claim;
- (vi) the collection, assessment, or recovery of a prepetition claim against the debtor, including any informal collection procedures, such as harassing phone calls or letters;
- (vii) any right to setoff a prepetition debt owing to the debtor against any claim against the debtor; and
- (viii) the commencement or continuation of proceedings in the United States Tax Court concerning a corporate debtor's tax liability for a taxable period which the bankruptcy court may determine, or the tax liability of an individual debtor for a taxable period ending before the entry of the order for relief.

One important caveat to the foregoing prohibited activities, however, is that financial institutions are permitted to place temporary administrative holds, or freezes, on a debtor's deposit accounts while the institution seeks relief from the stay to permit a setoff. *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995).

Section 362 of the Bankruptcy Code also expressly excepts certain actions from the automatic stay. These exceptions apply in voluntary and involuntary cases under the Bankruptcy Code as well as to applications under the Securities Investor Protection Act (or SIPA).<sup>25</sup> Although the automatic stay may not apply to such actions, the trustee or debtor-in-possession may affirmatively seek a stay of such actions under Section 105(a) of the Bankruptcy Code, which provides for permissive injunctive relief.

Pursuant to Section 362(b) of the Bankruptcy Code, the filing of a bankruptcy petition or a case under SIPA does not operate or continue to stay the following:

- (i) criminal actions against the debtor;
- (ii) various domestic relations actions, such as establishment of paternity, establishment of domestic support obligations, child custody or visitation actions, dissolution of a marriage, or regarding domestic violence, and various collection actions or remedies in connection therewith;
- (iii) acts to perfect or maintain or continue the perfection of an interest in property to the extent that the trustee's rights and powers are subject to such perfection under Section 546(b) of the Bankruptcy Code or to the extent that such perfection is accomplished within the grace period provided under Section 547(e)(2)(A) of the Bankruptcy Code;

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<sup>25</sup> SIPA is discussed more fully in Chapter VII.E.

- (iv) the exercise of police or regulatory powers to promote public health and safety, or against enforcement of a nonmonetary judgment arising from the exercise of such powers;<sup>26</sup>
- (v) setoffs in connection with commodity contracts, forward contracts, securities contracts, repurchase agreements, swap agreements, and one or more master netting agreements (to the extent that such master netting participant was eligible to exercise such offset rights under subsections (6), (7) or (17) of Section 362(b));<sup>27</sup>
- (vi) actions by the Secretary of Housing and Urban Development to foreclose mortgages insured under the National Housing Act and covering five or more living units;
- (vii) tax audits by a governmental unit, the issuance of a notice of tax deficiency by a governmental unit, a demand for tax returns, or the making of an assessment for any tax and issuance of a notice and demand for payment of such assessment (provided that any tax lien that would otherwise attach to property of the estate through an assessment shall not take effect unless such tax is a debt that will not be discharged, and the debtor will retain ownership of the property);
- (viii) actions by a landlord to recover nonresidential real property when the lease term expired prior to or during the administration of the case;
- (ix) presentment or notice of dishonor of negotiable instruments;
- (x) actions involving a Chapter 11 debtor brought more than ninety days after the filing of the petition by the Secretary of

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<sup>26</sup> However, if the government action is designed to protect only the government's pecuniary interests, it is stayed by the filing of a bankruptcy petition or a case under SIPA. See *In re Fucilo*, No. 00-36261, 2002 Bankr. LEXIS 475 (Bankr. S.D.N.Y. Jan. 24, 2002).

<sup>27</sup> For a complete discussion of a creditor's right to setoff in the case of these financial contracts, see Chapter V.G.1.

Transportation or the Secretary of Commerce to foreclose on certain ship mortgages;<sup>28</sup>

- (xi) actions by an accrediting agency or State licensing body regarding the licensure or accreditation status of the debtor as an educational institution and actions by a guaranty agency or the Secretary of Education regarding the debtor's eligibility to participate in programs authorized under the Higher Education Act;
- (xii) the creation or perfection of a statutory lien for an *ad valorem* property tax, or a special tax or special assessment on real property, where the tax or assessment became due postpetition;
- (xiii) the withholding and collection of amounts used to repay loans from a qualified pension, profit sharing, stock bonus or other such plan or from a qualified thrift savings plan;
- (xiv) a secured creditor's enforcement of a lien against or security interest in real property for a two-year period from the entry of an order in a prior case finding that the filing of the petition was part of a plan to delay, hinder and defraud creditors under 11 U.S.C. § 362(d)(4), provided that the debtor, in a subsequent case, may, upon notice and a hearing, seek relief from such order based upon changed circumstances or for other good cause shown;<sup>29</sup>
- (xv) a secured creditor's enforcement of a lien against or security interest in real property where (a) the debtor is ineligible to be a debtor pursuant to Section 109(g)<sup>30</sup> or (b) the case was filed in violation of a bankruptcy court order in a prior case prohibiting the debtor from being a debtor in another case;

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<sup>28</sup> This exception to the automatic stay applies only in cases filed on or before December 31, 1989.

<sup>29</sup> See Chapter V.C.3. for a discussion of Section 362(d)(4).

<sup>30</sup> See Chapter IV.A. for a discussion of the eligibility requirements for a debtor.

- (xvi) subject to Section 362(l) of the Bankruptcy Code, a real property lessor's continuation of any eviction, unlawful detainer or similar proceeding involving residential real property in which the debtor resides as a tenant and with respect to which the lessor had obtained a prepetition judgment for possession;
- (xvii) subject to Section 362(m) of the Bankruptcy Code, a lessor's continuation of an eviction action that seeks possession of residential property in which the debtor resides as a tenant based upon endangerment of such property or the illegal use of controlled substances on such property, provided that the lessor files with the court and serves a certification that such an eviction action had been filed, or that the debtor had endangered the property or illegally used or allowed to be used controlled substances on the property during the thirty-day period preceding the date of the filing of the certification;
- (xviii) any transfer not avoidable under Sections 544 and 549 of the Bankruptcy Code;<sup>31</sup>
- (xix) the commencement or continuation of an investigation or action by a securities self-regulatory organization to enforce its regulatory power, the enforcement of an order or decision obtained in an action by such securities self-regulatory organization to enforce its regulatory power or any act taken by such regulatory organization to delist, delete or refuse to quote any stock that does not meet applicable regulatory requirements;
- (xx) a taxing authority's setoff of a prepetition refund against a prepetition tax liability, provided that if the taxing authority is not permitted to setoff under applicable nonbankruptcy law due to a pending action to determine the amount or legality of the tax liability, the authority may hold the refund pending resolution of the action unless the court grants the authority adequate protection; and

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<sup>31</sup> See discussion of Sections 544 and 549 in Chapters V.F.3 and V.F.4. below.



- (xxi) the Secretary of Health and Human Services’ exclusion of the debtor from participating in the Medicare program or any other Federal healthcare program.

In the Chapter 11 context, Sections 1110 and 1168 of the Bankruptcy Code also place limitations on the scope of the automatic stay. In short, Sections 1110 and 1168 permit parties with a security interest in, or lessors or conditional vendors of, certain aircraft and related parts, ships, or railroad rolling stock to repossess the property despite the protection of the automatic stay unless the trustee agrees to perform the underlying contract or cure any defaults within sixty days of the commencement of the bankruptcy case. However, during the sixty days following the commencement of the bankruptcy, repossession is stayed. For a more complete discussion of this topic, see Chapter V.G.3.

### 3. *Relief from the Automatic Stay*

As noted above, in some instances, the court may grant a party in interest relief from the automatic stay. If a party in interest requests relief from the automatic stay, a court may grant such relief by conditioning, annulling, modifying, or completely terminating the automatic stay. 11 U.S.C. § 362(d).

According to 11 U.S.C. § 362(d)(1), the court shall grant relief from the automatic stay “for cause,” which includes the failure to provide “adequate protection” (11 U.S.C. § 361, detailed below at Chapter V.E.1.) of a party’s interest in property for the duration of the stay. The Bankruptcy Code also provides for relief from the stay with respect to property of the estate when the court finds that the debtor has no equity in the property and the property is unnecessary for an effective reorganization. 11 U.S.C. § 362(d)(2). Furthermore, where the debtor is a single asset real estate holding company,<sup>32</sup> the stay may be lifted after the later of ninety days from the date of entry of

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<sup>32</sup> “The term ‘single asset real estate’ means real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.” 11 U.S.C. § 101(51B).

the order for relief, or thirty days after the court determines that this Section applies, unless, prior thereto, the debtor files a plan of reorganization with a “reasonable possibility of being confirmed within a reasonable time” or is making monthly payments to its consensual mortgagees equal to the applicable nondefault contract rate of interest on the value of the mortgagee’s interest in the property. 11 U.S.C. § 362(d)(3). Finally, a court can lift the automatic stay for creditors whose claims are secured by an interest in real property where the court finds that the bankruptcy filing was part of a scheme to delay, hinder, and defraud creditors. 11 U.S.C. § 362(d)(4). Such a scheme must involve either (i) the transfer of all or part ownership of or interest in the property without the consent of the secured creditor or the approval of the court or (ii) multiple bankruptcy filings affecting the property. 11 U.S.C. § 362(d)(4)(A)–(B).

Moreover, as an additional protection, the Bankruptcy Code provides that if an order entered under Section 362(d)(4) of the Bankruptcy Code is properly recorded within two years of the entry of the order in compliance with State laws, such order shall be binding in any other bankruptcy case purporting to affect the real property. A debtor in a subsequent case may move for relief from such order if it can show that circumstances have changed or for good cause after notice and a hearing. *Id.*

A bankruptcy court must rule on a motion to lift the automatic stay within thirty days of the filing thereof or the stay is automatically terminated. 11 U.S.C. § 362(e)(1). However, the thirty-day period can be extended by consent of the parties. *Id.* Where a court has held a preliminary hearing on a request for relief from the stay, the final hearing must be held within thirty days from the conclusion of the preliminary hearing. *Id.* If the debtor is an individual, the automatic stay terminates sixty days after a request for relief from the stay is made unless the court makes a final decision prior thereto or the time period is extended by agreement of all parties-in-interest or by the court for good cause. 11 U.S.C. § 362(e)(2). An order granting relief from the automatic stay is stayed for fourteen days after the entry of the order unless the court orders otherwise. Fed. R. Bankr. P. 4001(a)(3).

In limited circumstances, such as when the facts indicate that a party’s interest in property will be irreparably harmed before there is an opportunity for notice and a hearing, the court may grant relief from the stay without

requiring formal, prior notice of a hearing or even a hearing itself. 11 U.S.C. § 362(f). However, according to Bankruptcy Rule 4001, the movant must certify what efforts have been made to give notice, explain why notice should not be required, and give oral notice immediately after the relief has been obtained. According to Bankruptcy Rule 4001(a)(2), the party adverse to the movant who obtained relief from the automatic stay can move for reinstatement of the stay after notice is given to the movant.

## D. Claims in Bankruptcy

### 1. *Definition of “Claim”*

The Bankruptcy Code defines the term “claim” in a very broad manner. According to Section 101(5)(A), the term “claim” means any “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.” A “claim” may also arise from a right to payment stemming from a right to an equitable remedy. 11 U.S.C. § 101(5)(B). However, since there must be a right to payment, an equitable claim that gives rise only to an equitable remedy, such as an injunction, is not considered a “claim.” Finally, an ownership or equity interest in a debtor is not considered a claim. See *In re Insilco Techs., Inc.*, 480 F.3d 212 (3d Cir. 2007).

### 2. *Types and Priority of Claims*

A claim holder’s ability to receive a recovery in a bankruptcy case will depend on the type and priority of the claim held. The most common claims a creditor may hold are administrative expense claims, secured claims, priority unsecured claims, and non-priority unsecured claims. Creditors that hold secured claims are entitled to preferential treatment with respect to their collateral, whereas other creditors are ranked in order of priority according to the Bankruptcy Code. Under this priority scheme, more senior claims must be paid in full before junior claims can recover anything.

### a. Administrative Expense Claims

As will be discussed in more detail below, administrative expense claims generally consist of claims that are incurred after the entry of the order for bankruptcy relief, although in certain instances claims incurred shortly before the petition date are also deemed to be administrative expense claims. Because these claims are generally incurred either shortly before or after a debtor has filed for bankruptcy, and therefore often evidence the willingness of a party to aid a debtor notwithstanding the debtor's precarious financial situation, administrative expense claims are given a senior level of priority. 11 U.S.C. § 507 (discussed below at Chapter V.D.2.c.).

In order for a creditor to receive payment of an administrative expense claim, it must make a timely request or demonstrate cause as to why a tardy request should be permitted. 11 U.S.C. § 503(a). Whether a request is timely or tardy is determined in relation to a court determined deadline (or "bar date") for the filing of such requests. In either case, however, notice and a hearing are required before an administrative expense claim will be allowed. *Id.*

The categories of administrative expenses included in Section 503(b) are as follows:

- (i) the actual, necessary costs and expenses of preserving the bankruptcy estate, including (a) wages, salaries, and commissions for services rendered postpetition, (b) wages and benefits awarded as back pay, attributable to any postpetition period, as a result of a violation of Federal or State law by the debtor, provided that the court determines that such payment "will not substantially increase the probability of layoff or termination of current employees, or of nonpayment of domestic support obligations" during the pendency of the case, and (c) taxes incurred by the estate, including property taxes (other than taxes specified in Section 507(a)(8) of the Bankruptcy Code) and taxes attributable to an excessive allowance of a tentative carryback adjustment that the estate received (whether the taxable year to which such

adjustment relates ended pre- or postpetition), and fines or penalties related to taxes in this category;<sup>33</sup>

- (ii) compensation and reimbursement awarded under Section 330 (which provides for reasonable compensation and reimbursement of expenses for actual and necessary services awarded to a trustee, examiner, ombudsman, debtor’s attorney or other professional person retained with statutory authorization);
- (iii) the actual, necessary expenses, other than those specified in paragraph (iv) below, incurred by (a) a creditor that files an involuntary petition, (b) a creditor who, with court approval, recovers, for the benefit of the estate, property transferred or concealed by the debtor, (c) a creditor who assists with the prosecution of a criminal offense relating to the case or to the business or property of the debtor, (d) a creditor, indenture trustee, equity security holder, or unofficial committee that makes a “substantial contribution” to a Chapter 9 or Chapter 11 case, (e) a custodian replaced under the provisions of Section 543, or (f) a member of a committee appointed under Section 1102 of the Bankruptcy Code;
- (iv) reasonable compensation for professional services rendered by attorneys or accountants employed by an entity, indenture trustee, equity security holder, committee or custodian whose expenses are allowable pursuant to (iii)(a) through (e) above, and reimbursement for such professional’s actual, necessary expenses;<sup>34</sup>
- (v) reasonable compensation for the services of an indenture trustee in making a substantial contribution to a Chapter 9 or 11 case;
- (vi) fees and mileage payable to a witness attending court proceedings;

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<sup>33</sup> Also included in this category are the costs of obtaining postpetition unsecured credit in the ordinary course of business pursuant to Section 364 of the Bankruptcy Code. For a complete discussion of Section 364 of the Bankruptcy Code, see Chapter V.E.4.

<sup>34</sup> Categories (iii) and (iv) above are collectively commonly referred to as “503(b) claims.”

- (vii) with respect to a nonresidential real property lease previously assumed under Section 365, and subsequently rejected, a sum equal to the monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, for a period of two years from the later of rejection or actual turnover of the premises, with the balance of the rejection claim being a general unsecured claim which would be subject to the limitations of the so-called “502(b)(6) limitation” discussed in Chapter V.D.5.;
- (viii) the actual, necessary costs and expenses of closing a health care business, including any costs incurred in disposing of patient records or transferring patients; and
- (ix) the value of any goods received by the debtor within twenty days before the commencement of a case where the goods have been sold to the debtor in the ordinary course of such debtor’s business (the so-called “503(b)(9) claims”).

Additionally, Section 503(c) of the Bankruptcy Code limits a debtor’s ability to pay retention bonuses or severance payments to its insiders. Specifically, Section 503(c)(1) limits payments made to an insider of the debtor for the purpose of inducing such person to remain with the debtor’s business. However, the court may allow such payments if the following three tests have been satisfied. First, the court must find that the payment or obligation is essential to retention of the person because such person has a bona fide job offer from another business at the same or greater rate of compensation. 11 U.S.C. § 503(c)(1)(A). Second, the court must find that the services provided by the employee to be retained are essential to the survival of the business. 11 U.S.C. § 503(c)(1)(B). Third, the court must find that either (i) the amount of the payment or obligation is not greater than ten times the amount of the average payment or obligation given to nonmanagement employees for any purpose during the calendar year, or (ii) if no such payments or obligations were made in the calendar year, the amount of the payment or obligations cannot exceed twenty-five percent of any retention award granted to the insider during the previous year. 11 U.S.C. § 503(c)(1)(C).

Section 503(c)(2) further limits severance payments to an insider if the payment is not part of a program that is generally applicable to all full-time employees or the amount of the payment to the insider is greater than ten times the amount of the average severance pay given to nonmanagement employees during the calendar year.

Finally, Section 503(c)(3) is a somewhat narrow “catch all” that limits transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition.

## b. Secured Claims

The Bankruptcy Code establishes a number of special rights and protections available to the holders of secured claims. The Bankruptcy Code is guided by the principles that secured creditors are entitled to priority payment out of their collateral, and secured creditors are entitled to receive the equivalent value of their collateral. Such holders are entitled to “adequate protection” and, in some cases, relief from the automatic stay. Congress granted such special protections and rights to secured creditors to reflect the benefit of their bargained-for rights.

Under the Bankruptcy Code, creditors’ claims are initially divided into two categories: secured claims and unsecured claims. According to Section 506(a)(1), an allowed secured claim is (i) an allowed claim, (ii) secured by a lien, (iii) on property in which the estate has an interest. A secured claim is secured to the extent of the value of the creditor’s interest in the debtor’s interest in the property. *Id.* Additionally, if there is a right to a setoff, the amount subject to setoff is usually treated as if it were a secured claim. *Id.* An unsecured claim, on the other hand, is a claim held by a creditor that has not obtained a security interest in any collateral to protect against default on its underlying obligation.

A secured creditor may be considered oversecured or undersecured. If the value of the collateral secured by a lien exceeds the amount of a creditor’s claim, a creditor is said to be oversecured. Oversecured creditors are entitled to postpetition interest and reasonable fees, costs, or charges provided under an agreement or State statute. 11 U.S.C. § 506(b). However, if the value of the creditor’s interest in the collateral is less than the value of the claim, the

creditor is said to be undersecured. According to Section 506(a)(1), an undersecured creditor has a secured claim up to the value of the collateral and an unsecured claim for any remaining claim. In a Chapter 11 case, an undersecured creditor may choose to elect to have the entire allowed amount of its claim treated as a secured claim pursuant to Section 1111(b). If this election is made, the creditor must receive payments on its claim which aggregate the amount of the indebtedness but have a present value equal to only the value of the collateral securing the claim.

Because the value of collateral directly affects the secured status of a claim, valuation is a very important issue in a bankruptcy proceeding. Property may be valued in different amounts at different points in a case depending on the purpose for the valuation or the actual fluctuation in the value of the property. The Bankruptcy Code provides that value be determined in light of the purpose of the valuation and the proposed disposition or use of the property, and in conjunction with a hearing on the disposition or use of the property or on confirmation of a plan. 11 U.S.C. § 506(a)(1). Generally, the standard used to value collateral is one of fair market value. However, in almost all cases, the determination of fair market value will depend on the particular market and the means selected to gauge the value of the item in question.

### c. Priority Unsecured Claims

Once secured claims have been satisfied out of the applicable collateral, the Bankruptcy Code provides that particular types of unsecured claims receive priority in payment over other unsecured claims. Section 507 of the Bankruptcy Code outlines ten types of such priority claims. All claims in a higher priority category are satisfied in full before payment is made to lower priority categories if the priorities are strictly enforced. If an unsecured claim is not covered by one of the priorities, the claim holder must wait until all priority claim holders are paid in full before it can receive any payment. Normally, courts may not alter the priority scheme, but creditors may agree in a plan of reorganization to different treatment (subject to the requirements of Chapter 11). Moreover, subordination provisions and intercreditor agreements, which modify the order of payment of claims, are enforceable with respect to the payment of claims. 11 U.S.C. § 510(a) (more fully discussed in Chapter V.D.2.e.).



The Bankruptcy Code also provides that some claims may be given super priority treatment. For instance, according to Section 364(c), a lender that provides debtor-in-possession financing (or “DIP Financing”), discussed in greater detail in Chapter V.E.4., will receive “super priority” treatment and will be entitled to payment before other administrative expenses.

The Bankruptcy Code provides for priority claims to be paid in the following order:

- (i) claims for certain domestic support obligations of an individual debtor;
- (ii) claims for allowed administrative expenses under Section 503(b);<sup>35</sup>
- (iii) ordinary course claims that arose between the filing of an involuntary petition and the entry of the order for relief;
- (iv) claims for wages, salaries, or commissions, including vacation, severance, and sick leave pay, earned by an individual within the earlier of 180 days before the petition date or the date of the cessation of the debtor’s business, but only to the extent of \$11,725 per individual;
- (v) claims for contributions to employee benefit plans for services rendered after the earlier of (a) 180 days prior to the date on which the debtor ceased business operations or (b) 180 days prior to the petition date in an amount per employee equal to \$11,725 less the amount paid to each such employee under the fourth priority (paragraph (iv) above) plus the amount paid by the estate on behalf of an individual employee to any other employee benefit plan;
- (vi) claims up to \$5,775 of creditors engaged in the production or raising of grain against debtors who own or operate grain storage facilities, and of U.S. fisherman against debtors who acquire fish or fish produce and who are engaged in operating a fish produce storage or processing facility;

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<sup>35</sup> For a complete discussion of Administrative Expense Claims, see Chapter V.D.2.a.

- (vii) claims up to \$2,600 of individual consumer creditors arising from the deposit of money for the purchase, lease, or rental of property, or the purchase of services for personal, family or household use;
- (viii) claims for certain prepetition taxes owed to a governmental unit, including various taxes measured by income or gross receipts, property taxes, trust fund taxes, employment taxes, excise taxes, and customs duties;
- (ix) claims based upon commitments to a Federal regulatory agency to maintain the capital of an insured depository institution; and
- (x) claims for death or personal injury resulting from the illegal operation of a motor vehicle by the debtor while intoxicated from alcohol, drugs or another substance.

According to Section 507(d), if a creditor is subrogated to a claim that would otherwise receive priority, the subrogated claimant may not receive priority status if it is a claim arising under roman numeral (i), (iv), (v), (vi), (vii), (viii), or (ix) listed above.

#### d. Non-Priority Unsecured Claims

Creditors holding unsecured claims that do not fall into one of the priorities outlined in Section 507 usually receive a *pari passu* distribution out of the remaining assets of the estate in accordance with the size of their claim after the secured creditors have enforced their security and the priority claimants have exhausted their claims. These claims are commonly referred to as “general unsecured claims.”

#### e. Subordination of Claims

Section 510 of the Bankruptcy Code provides for the subordination of claims. Generally, subordination of a claim means that the priority level for recovery for such claim is reduced below the priority level to which claims of such type would normally be entitled under the Bankruptcy Code due to the particular circumstances surrounding the claim at issue. This can negatively impact the likelihood that the holder of such claim will receive or retain a

distribution in the bankruptcy on account of such claim. As discussed below, the subordination of a claim can occur in one of three ways: (i) subordination by agreement (otherwise known as contractual subordination); (ii) subordination of claims arising out of certain securities transactions; and (iii) equitable subordination. 11 U.S.C. § 510.

In Section 510(a), the Bankruptcy Code recognizes consensual subordination agreements and provides that a “subordination agreement is enforceable . . . to the same extent that such agreement is enforceable under applicable nonbankruptcy law.” 11 U.S.C. § 510(a). For example, one or more creditors (the “Subordinated Creditors”) may agree to subordinate their right to payment of their claims to the claims of one or more creditors (the “Senior Creditors”) in the event of bankruptcy through an intercreditor agreement or subordination provision in one or both of the agreements at issue. In the event of a bankruptcy, and absent different plan treatment or compromise, the claims of the Subordinated Creditors would be entitled to a *pro rata* distribution vis-à-vis the other creditors in that class, but their actual distributions would be paid over to the Senior Creditors to the extent provided in the relevant agreements.

Section 510(b) of the Bankruptcy Code provides for the subordination of claims for (i) rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, (ii) damages arising from the purchase or sale of such security, or (iii) reimbursement or contribution allowed under Section 502 on account of any such claims. These claims will be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security. 11 U.S.C. § 510(b). However, if the security giving rise to the claim is common stock, the subordinated claim will have the same priority as common stock. *Id.* Subordination under this provision is mandatory rather than discretionary. The purpose of Section 510(b) is to prevent interest holders from raising their seniority level in the Bankruptcy Code priority scheme by effectively converting their equity interests into claims.

The doctrine of equitable subordination is found in Section 510(c)(1) of the Bankruptcy Code and encompasses the case law developed by courts under the Bankruptcy Act. This subsection provides for the subordination of all or part of an allowed claim to all or part of another allowed claim (or all or part of an allowed equity interest to all or part of another allowed equity

interest) based upon “principles of equitable subordination.” 11 U.S.C. § 510(c)(1). The term “principles of equitable subordination” is not defined in the Bankruptcy Code, but has been developed by courts as a three-pronged test requiring that:

- (i) the claimant must have committed fraud or other inequitable conduct;
- (ii) the claimant’s conduct must have resulted in harm to other creditors or in an unfair advantage to the claimant; and
- (iii) the subordination of the claim will not be contrary to the principles of bankruptcy law.

See *In re Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1997); *Shubert v. Lucent Techs. Inc. (In re Winstar Commc’ns, Inc.)*, 554 F.3d 382 (3d Cir. 2009).

If the requirements of equitable subordination are not met, bankruptcy courts can also use their equitable powers under Section 105 to “recharacterize” a debt claim as equity. Recharacterization may be available even if subordination or disallowance are not. When an equity holder extends a loan to a debtor at a time when the debtor is in such a financially poor condition that other lenders would not have made such a loan, a bankruptcy court may recharacterize such a loan as an “equity security” under Section 101(16), and not a “debt” under Section 101(12). *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448 (3d Cir. 2006). Thus, recharacterization could significantly reduce the probability of a recovery for such a claim.

Bankruptcy courts use the following eleven factors to assess whether recharacterization is warranted:

- (iv) the names given to the instruments, if any, evidencing the indebtedness;
- (v) the presence or absence of a fixed maturity date and schedule of payments;
- (vi) the presence or absence of a fixed rate of interest and interest payments;

- (vii) the source of repayments;
- (viii) the adequacy or inadequacy of capitalization;
- (ix) the identity of interest between the creditor and the stockholder;
- (x) the security, if any, for the advances;
- (xi) the corporation's ability to obtain financing from outside lending institutions;
- (xii) the extent to which the advances were subordinated to the claims of outside creditors;
- (xiii) the extent to which the advances were used to acquire capital assets; and
- (xiv) the presence or absence of a sinking fund to provide repayments.

*In re SubMicron Sys. Corp.*, 432 F.3d at 456.

### 3. *Setoff and Recoupment*

#### a. *Setoff*

Setoff is a doctrine based as much on practical considerations as on equitable ones. As numerous courts have observed, setoff “is grounded on the absurdity of making A pay B when B owes A.” *Studley v. Boylston Nat’l Bank*, 229 U.S. 523, 528 (1913). The Bankruptcy Code does not create any rights of setoff, but instead merely preserves such rights to the extent that they both exist under applicable nonbankruptcy law and either satisfy the various conditions set forth in Section 553 of the Bankruptcy Code or are protected by the so-called “safe harbor” provisions of the Bankruptcy Code applicable to securities contracts, swap agreements, commodity contracts, forward contracts and repurchase contracts. See *U.S. v. Maxwell*, 157 F.3d 1099, 1102 (7th Cir. 1998); *In re Delta Airlines, Inc.*, 341 B.R. 439, 443 (Bankr. S.D.N.Y. 2006).<sup>36</sup>

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<sup>36</sup> For a discussion of the safe harbor provisions of the Bankruptcy Code, see Chapter V.G.1.b. below.

Generally speaking, Section 553 protects a creditor's setoff rights where four requirements are satisfied: (i) the creditor holds a claim against the debtor that arose prepetition; (ii) the creditor owes a debt to the debtor that also arose prepetition; (iii) such claim and debt are "mutual;" and (iv) such claim and debt are each valid and enforceable. 11 U.S.C. § 553(a). Even if a right of setoff exists, however, Section 362(a)(7) stays setoff, requiring a party to seek court permission before exercising such right. Setoffs taken in violation of the automatic stay are void and without legal effect. Notwithstanding the foregoing, a creditor may protect its right of setoff by temporarily withholding payment of a debt owed to the debtor without violating the automatic stay. See *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995).

Setoffs are prohibited, however, in the following circumstances: first, where the creditor's claim against the debtor is disallowed; second, where the creditor acquired the claim from another creditor either after the bankruptcy filing or within the ninety days preceding the petition date while the debtor was insolvent; and finally, where the creditor incurred the debt owed to the debtor for the purpose of obtaining a setoff against the debtor within the ninety days preceding the petition date while the debtor was insolvent. 11 U.S.C. § 553(a)(1)–(3). In addition, setoffs where the creditor has "improved its position" in the ninety days preceding the petition date are prohibited. Section 553(b)(1) provides that, except with respect to setoffs that are protected by the Bankruptcy Code's safe harbor provisions, if a creditor exercises its right of setoff against the debtor within the ninety days preceding the petition date, the trustee is entitled to recover from such creditor the amount offset to the extent that any insufficiency on the date of the setoff is less than the insufficiency on the later of (i) ninety days before the petition date or (ii) the first date during the ninety days preceding the petition date on which there is an insufficiency. In this context, the Bankruptcy Code defines "insufficiency" as the "amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim." 11 U.S.C. § 553(b)(2).

Of the four requirements of Section 553 discussed above, mutuality creates the most confusion. Although courts agree that mutuality should be strictly construed, see, e.g., *Kitaeff v. Vappi & Co.*, 140 B.R. 608 (Bankr. D. Mass. 1992), the term "mutual" is not defined by the Bankruptcy Code. The

confusion surrounding mutuality is hardly alleviated by the fact that courts have interpreted the word to encompass a variety of concepts, including whether the claim and debt were owed by the same parties, whether such parties were acting in the same capacity, and whether the obligations were owed in the same right. See *Von Gunten v. Neilson (In re Slatkin)*, 243 Fed. Appx. 255 (9th Cir. 2007). Courts have also held that mutuality does not exist where one of the debts was incurred prepetition and the other debt was incurred postpetition. This is because “the debtor and the debtor-in-possession are two separate and distinct entities, which act in different capacities pre- and post-petition. Therefore, pre-petition claims may only be setoff against pre-petition claims, and post-petition claims may only be setoff against pre-petition claims.” *Genuity Solutions, Inc. v. Metro. Trans. Auth. (In re Genuity, Inc.)*, No. 02-43558, 2007 Bankr. LEXIS 2133, at \*13-14 (Bankr. S.D.N.Y. June 20, 2007).

### *i. Triangular Setoff*

While, as noted above, the right of setoff typically applies where there are debts owing between two entities, parties may sometimes attempt to expand their setoff rights by seeking to set off a debt against the other party’s obligation to a third party. Although this right may be enforceable outside bankruptcy, in general, these so-called “triangular setoffs” have met with some resistance in bankruptcy. See *In re Semcrude, L.P.*, 399 B.R. 388, 393 (Bankr. D. Del. 2009). This is true even where the creditor and the third party are related entities. See, e.g., *In re Okura & Co.*, 249 B.R. 596, 608-09 (Bankr. S.D.N.Y. 2000). Notwithstanding the foregoing, however, some courts have suggested that Section 553 preserves these “triangular setoffs” in certain limited circumstances—specifically, where the parties have contractually agreed to permit triangular setoff among themselves. See *In re Semcrude, L.P.*, 399 B.R. 388, 394 n.4.<sup>37</sup>

At least one court, however, has refused to uphold triangular setoff even where the parties thereto agreed to it. In *In re Semcrude, L.P.*, the Delaware Bankruptcy Court ruled that debts among different parties could not be deemed mutual even in the face of an agreement that expressly contemplated

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<sup>37</sup> Although, as discussed in the following paragraph, this court specifically prohibited a triangular setoff, the footnote reference provides a list of cases that have held that triangular setoffs are permitted.

triangular setoff. 399 B.R. 388. The court adopted a narrow interpretation of “mutuality,” finding that debts between parties are mutual only if the debts are “due to and from the same persons in the same capacity.” From such a perspective, triangular setoff language cannot create mutuality.<sup>38</sup> The *Semcrude* decision thus suggests that triangular setoff will continue to meet with resistance in bankruptcy, at least in the context of contracts not subject to the protections afforded by the Bankruptcy Code’s safe harbor provisions.

An exception to the general rule against triangular setoff does exist, however, where more than one agency of the Federal government is involved. Under the so-called “unitary creditor” theory, one Federal agency may be permitted to set off a claim against a debtor against an obligation owed to such debtor by a separate Federal agency. The rationale behind this exception is that because the Bankruptcy Code neither expands nor constricts the common law right of setoff but simply preserves whatever right exists outside bankruptcy, and because the Federal government is considered to be a single entity that can set off one agency’s debt to a party against such party’s obligation to another agency outside of bankruptcy, such rule also applies in bankruptcy. See *U.S. v. Maxwell*, 157 F.3d 1099, 1102 (7th Cir. 1998).

## b. Recoupment

Recoupment is an equitable doctrine which permits a party to reduce the amount of a counterparty’s claim by asserting a claim against the counterparty arising out of the same transaction. See *Delta Airlines, Inc. v. Bibb (In re Delta Airlines)*, 359 B.R. 454 (Bankr. S.D.N.Y. 2006). Although recoupment applies in bankruptcy proceedings, the doctrine is not referenced in the Bankruptcy Code and is not subject to the limitations of Section 553 or the automatic stay. *Id.* at 467. Thus, for example, recoupment does not require that there be mutuality between the parties or that both of the obligations at

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<sup>38</sup> The creditor later filed a motion for reconsideration of the court’s decision in *In re Semcrude, L.P.*, arguing that the contracts at issue were “safe harbor” contracts and should thus be protected against any Section of the Bankruptcy Code, including Section 553, operating to limit the setoff provisions of such contracts. The court denied the creditor’s motion on a procedural point, finding that the Bankruptcy Rules did not “permit reconsideration to allow a party a ‘second bite at the apple’ to assert grounds for recovery that could have been asserted in the first instance. *In re Semcrude, L.P.*, No. 08-11525, Docket No. 3465 (Bankr. D. Del. March 19, 2009).



issue arise prepetition (so long as they arise out of the same transaction). Perhaps even more significantly, recoupment is not prohibited by the automatic stay, and a creditor is free to exercise its right of recoupment without seeking court approval.

Courts have been reluctant to define precisely what constitutes a “single transaction” for recoupment purposes, “focusing instead on the facts and the equities of each case.” *U.S. v. Dewey Freight Sys., Inc.*, 31 F.3d 620, 623 (8th Cir. 1994). Most courts apply one of two approaches when determining if certain events and obligations satisfy the “single transaction” standard. Courts that consider this issue under the framework of the “logical relationship” test adopt a fairly permissive view of the case before them, guided by the following principle: transaction “is a word of flexible meaning. It may comprehend a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship.” *Moore v. New York Cotton Exchange*, 270 U.S. 593, 610 (1926). Other courts take a stricter view and apply the “integrated transaction” test. These courts conclude that in a bankruptcy, recoupment may only be applied where both debts “arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations.” *Westinghouse Credit Corp. v. D’Urso*, 278 F.3d 138, 147 (2d Cir. 2002) (quoting *In re Univ. Medical Ctr.*, 973 F.2d 1065, 1081 (3d Cir. 1992)). Although both approaches require courts to consider the underlying equities of the case, the tests are distinguishable from one another by the degree of interrelatedness required as to the obligations owing between the parties.

#### 4. *Filing Proofs of Claim or Interest or Equity Holder*

In order for a creditor or equity holder to receive a distribution out of a debtor’s bankruptcy estate, such creditor or equity holder (or another appropriate person) must, as a first step, ordinarily file a proof of claim or interest, as applicable. According to Section 501 of the Bankruptcy Code, a creditor may file a proof of claim and an equity holder may file a proof of interest. If a creditor does not timely file a proof of claim, a debtor, trustee or co-debtor may file the proof of claim on the creditor’s behalf. 11 U.S.C. § 501(b)–(c).

In cases other than a Chapter 11 case, filing a proof of claim is a mandatory prerequisite for the allowance of unsecured claims, including priority claims and undersecured claims. However, in a Chapter 11 case, a creditor need not file a proof of claim in all instances in order to have an allowed claim in the bankruptcy case. For example, if the claim has been properly listed on the debtor's schedule of liabilities, then no proof of claim is required. However, if the claim or interest in a Chapter 11 case is not listed, is listed in an incorrect amount or priority, or is listed as disputed, contingent or unliquidated, a proof of claim must be filed.

The time within which a creditor must file its proof of claim varies depending on the type of case. In a Chapter 7 or Chapter 13 case, subject to the exceptions listed in Bankruptcy Rule 3003, a proof of claim must be filed within ninety days after the date set for the first meeting of creditors. In a Chapter 11 case, the court will fix a "bar date," which is the time by which proofs of claim must be filed. Fed. R. Bankr. P. 3003. As a general matter, late filed claims are subject to disallowance (or, in Chapter 7 cases, subordination).

### *5. Allowance of Claims or Interests*

Section 502 of the Bankruptcy Code provides the rules for determining whether a claim is allowed. It is important to determine whether a claim is allowed because the rights of a holder of a claim will hinge on whether the claim is allowed or not. In particular, only holders of allowed claims may receive distributions in Chapter 7 cases or under confirmed plans in Chapters 9, 11, 12, and 13 cases.

Under Section 502, a claim will be deemed allowed by (i) the filing of a proof of claim if no party in interest objects to the claim, (ii) court approval if an objection to the claim is filed under Section 502(b), or (iii) court estimation under Section 502(c).

If a party in interest objects to a proof of claim, the court, after notice and a hearing, will determine whether, and in what amount, the claim will be allowed. 11 U.S.C. § 502(b). However, Section 502 of the Bankruptcy Code provides that the following types of claims will not be allowed:

- (i) when, under any agreement or applicable law, the claim is unenforceable against the debtor or its property for a reason other than because it is contingent or unmaturing;

- (ii) a claim for unmatured interest (*i.e.*, postpetition interest);
- (iii) a property tax claim to the extent the claim exceeds the value of the property;
- (iv) a claim for services of an insider or attorney of the debtor to the extent it exceeds the reasonable value of the services;
- (v) a claim for a postpetition domestic support obligation, which is nondischargeable in bankruptcy and is paid from the debtor's property acquired after the filing date;
- (vi) the claim of a landlord for damages resulting from rejection of a real property lease that exceeds (a) the amount of the rent reserved under the lease for the greater of one year or fifteen percent (15%) of the remaining term of the lease, not to exceed three years following the earlier of the petition date and the date on which the leased property was returned to the lessor plus (b) any unpaid rent due under such lease on the earlier of such dates (the so-called "502(b)(6) limitation");
- (vii) an employee's claim for damages stemming from the termination of an employment contract which exceeds (a) the compensation provided by the contract for the one year following the earlier of the filing date or the termination date plus (b) any unpaid compensation due under such contract on the earlier of such dates;
- (viii) claims resulting from a reduction of an otherwise available Federal tax credit when the reduction occurs because of late payment of certain State employment taxes; and
- (ix) claims filed after any applicable bar date, except late-filed proofs of claim specifically permitted by the Bankruptcy Code or Rules, a claim filed by a governmental unit filed within 180 days of the commencement of the case or as provided in the Bankruptcy Rules, or in Chapter 13 cases, claims of governmental units for a tax filed within sixty days of the filing of a prepetition tax return.

Furthermore, Section 502(d) provides that a claim of either a transferee of an avoidable transfer or an entity from whom property is recoverable under certain Sections of the Bankruptcy Code will not be allowed if the claimant has not paid the amount or turned over the property received. Such claimant may file a proof of claim, but Section 502(d) will disallow such claim until the claimant repays any payment or returns the transferred property. Because Section 502(d) explicitly refers to transfers “avoidable” (and property “recoverable”) and not to transfers that have actually been avoided (or property actually recovered), a trustee need not have actually avoided the transfer (or recovered the property) in order to object to a claim. *See, e.g., El Paso v. America West Airlines, Inc. (In re America West Airlines, Inc.)*, 217 F.3d 1161 (9th Cir. 2000). Finally, it is important to note that Section 502(d) applies only to avoidable transfers made and liens granted by a debtor and not to obligations incurred by a debtor. 11 U.S.C. § 502(d).

The Bankruptcy Code further provides that certain claims will be considered prepetition claims even if they arose or became fixed after the petition date. These include: (i) “involuntary gap claims” (11 U.S.C. § 502(f)); (ii) claims for reimbursement or contribution (11 U.S.C. § 502(e)(2)); (iii) claims arising from the rejection of an executory contract or unexpired lease (11 U.S.C. § 502(g)); (iv) claims arising from recovery of property (11 U.S.C. § 502(h)); and (v) claims for taxes entitled to priority (11 U.S.C. § 502(i)).

A claim that has been allowed or disallowed may be reconsidered for cause according to the equities of the case. 11 U.S.C. § 502(j). Bankruptcy Rule 3008 also stipulates that a party in interest may move for reconsideration of an order allowing or disallowing a claim.

Finally, Section 502(k) permits the reduction of an otherwise valid claim based upon an unsecured consumer debt due to the failure of a creditor to negotiate with the debtor prepetition regarding a repayment schedule for the claim. On motion of the debtor, the court, after a hearing, may reduce such a claim by up to twenty percent of the claim. For such a reduction to be granted the following additional elements must be met: (i) the alternative payment schedule must have been proposed by an approved nonprofit budget and credit counseling agency; (ii) the offer was made at least sixty days prior to the petition date; (iii) the offer provided for a payment of at least sixty

percent of the amount of the debt over a time period not to exceed the repayment period of the loan, or a reasonable extension thereof; and (iv) no part of the debt under the alternative repayment schedule could be deemed nondischargeable. 11 U.S.C. § 502(k).

## 6. *Estimation of Claims*

When fixing or liquidating a contingent or unliquidated claim would unduly delay the administration of a case, the court can order that such claim be estimated pursuant to Section 502(c). 11 U.S.C. § 502(c)(1). A right to payment that arises from an equitable remedy for breach of performance may also be estimated pursuant to Section 502(c). 11 U.S.C. § 502(c)(2). However, if a contingent or unliquidated claim can be liquidated in the ordinary course without causing undue delay in the administration, it should not be estimated. See *In re Bison Resources, Inc.*, 230 B.R. 611, 618 (Bankr. N.D. Okla. 1999). A court may use any method of estimation appropriate under the circumstances of a particular case as long as the method used conforms to generally recognized legal principles.<sup>39</sup> Furthermore, an expert may advise the court or be authorized to prepare an estimate.

## 7. *Claims Trading*

The filing of a bankruptcy petition provides many prepetition creditors with incentives to sell their claims because of the uncertainty as to the timing, amount, and form of any distributions ultimately to be received in the bankruptcy case. The filing of the bankruptcy petition also aids the ability of prospective buyers to find prepetition claims due to the public nature of the proceedings and the filings made therein.<sup>40</sup> As a result, a robust market for claims in bankruptcy cases has developed.

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<sup>39</sup> As discussed in Chapter II.B.1., the Bankruptcy Court does not have jurisdiction over personal injury, tort or wrongful death actions, which matters are to be heard by the District Court.

<sup>40</sup> For a discussion of the public nature of bankruptcy proceedings and filings, see Chapter IV.C. above.

## E. Administrative Powers

### 1. Adequate Protection

In certain instances, where a creditor's rights vis-à-vis property of the debtor's estate are diminished, the Bankruptcy Code permits such creditor to request that the court condition the debtor's use of such property on the grant of "adequate protection" of the creditor's interest in such property.<sup>41</sup> Adequate protection is relevant when relief from the automatic stay is requested (11 U.S.C. § 362(d)), in dealing with the trustee's or debtor-in-possession's general authorization to use, sell, or lease property (11 U.S.C. § 363), or when existing lien-holders would be negatively affected by postpetition credit secured by a senior or equal lien on the existing creditor's collateral (11 U.S.C. § 364(d)). Although the Bankruptcy Code does not define the concept of adequate protection it does provide a non-exhaustive list of actions that may constitute adequate protection. 11 U.S.C. § 361.

A debtor may provide adequate protection by (i) making single or periodic cash payments to the creditor whose interest will be affected, (ii) granting the creditor an additional or replacement lien, or (iii) granting the creditor the "indubitable equivalent" of its interest in the property. *Id.*

An additional or replacement lien is particularly appropriate in a situation where, in order to continue the debtor's business, the trustee proposes to use or dispose of property subject to a creditor's floating lien. In such a case, an alternative lien in inventory or accounts receivable may be designed to provide adequate protection.

The third alternative, the so-called "indubitable equivalent" requirement, is a catch-all derived from Judge Learned Hand's decision in *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935), and was initially used to mean "complete compensation." Under this Section, which applies when cash payments or replacement liens are not feasible, parties are given great flexibility in fashioning appropriate protection with the sole requirement being the provision of "indubitable equivalent" value. In the case of an oversecured creditor, adequate protection may be provided by an "equity cushion." An "equity cushion" is the excess value of the collateral over the amount of the debt. An equity cushion is generally considered to provide

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<sup>41</sup> This concept is derived from the Fifth Amendment to the U.S. Constitution.

adequate protection as long as it is of sufficient size, but the trustee or debtor-in-possession may not erode it entirely.

It is important to note that undersecured creditors can not argue that their claim to postpetition interest or other payments in compensation for investment opportunities lost as a result of the bankruptcy proceeding are not adequately protected. See *United Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365 (1998).

Finally, it is also important to note that a “secured creditor is entitled to adequate protection only upon motion and only prospectively from the time such protection is sought.” *In re Best Prods. Co.*, 138 B.R. 155, 157 (Bank. S.D.N.Y. 1992).

## 2. Use, Sale and Lease of Property

Section 363 of the Bankruptcy Code defines the rights and powers of a debtor-in-possession or a trustee<sup>42</sup> with respect to the use, sale or lease of property of the estate and sets forth the rights of other parties who have interests in such property. This Section is applicable in Chapter 7 and 11 cases, and, with limitations, in a Chapter 13 case.

### a. Generally

At the most basic level, the Bankruptcy Code differentiates between two types of transactions that occur in any business operation: transactions that are normal and routine, *i.e.*, transactions “in the ordinary course,” and transactions that are not typical to a debtor’s business, *i.e.*, transactions “not in the ordinary course.” According to Section 363(c)(1), if the business of a debtor is authorized to be operated under Section 721, 1108, 1203 or 1304 of the Bankruptcy Code, the trustee may use, sell, or lease property of the estate (other than cash collateral, discussed below in Chapter V.E.2.b.) in the ordinary course of business without notice and a hearing. Thus, in a typical Chapter 11 case, normal business operations will proceed much as before the filing. However, pursuant to Section 363(b)(1), a trustee or debtor-in-

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<sup>42</sup> For purposes of the discussion of Section 363 of the Bankruptcy Code, references to a “trustee” also encompass a debtor-in-possession in the Chapter 11 context. See Chapter VI.A. for a complete discussion of the treatment of a debtor-in-possession.

possession must provide notice and a hearing before property of the estate may be used, sold or leased other than in the ordinary course of business.<sup>43</sup>

The Bankruptcy Code does provide three general limitations on the right to use, sell or lease property: (i) the trustee must comply with applicable nonbankruptcy law that governs the transfer of property by a corporation or trust that is not a moneyed business or commercial corporation or trust (11 U.S.C. § 363(d)(1)); (ii) regardless of the context of the action, the trustee may not take action inconsistent with court orders providing relief from the automatic stay (11 U.S.C. § 363(d)(2)); and (iii) when a party in interest so requests, the court may deny or condition a proposed or actual use, sale or lease as is necessary to ensure adequate protection of the party's interest in the property at issue (11 U.S.C. § 363(e)).

Additionally, the Bankruptcy Code provides that a trustee's rights under Section 363 are not altered by nonbankruptcy laws or contract provisions that are conditioned on the insolvency of the debtor or the filing of a petition. 11 U.S.C. § 363(l). Moreover, a purchaser or lessee of property of the estate is protected from a reversal on appeal of the sale or lease as long as the purchaser or lessee acted in good faith and the appellant failed to obtain a stay of the sale or lease. 11 U.S.C. § 363(m). Finally, Section 363(n) allows the trustee to avoid a sale when the price was controlled by an agreement among collusive bidders.

## b. Cash Collateral

One exception to the foregoing general rules regarding the use, sale and lease of estate property is when the use relates to the use by the trustee or debtor-in-possession of cash that is a creditor's collateral. This is because of the nature of cash as compared to other assets. The Bankruptcy Code provides that the trustee or debtor-in-possession may not use, sell or lease "cash collateral" without either (i) the consent of the creditor with an interest in the collateral or (ii) court authorization, granted after notice and a hearing. 11 U.S.C. § 363(c)(2). "Cash Collateral" is defined as including cash, negotiable instruments, documents of title, securities, deposit accounts or

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<sup>43</sup> See Chapter VI.C. for a discussion of the operation of a debtor's business in a bankruptcy proceeding.



other cash equivalents whenever acquired in which the estate and another entity have an interest. 11 U.S.C. § 363(a). It also includes all proceeds, products, offspring, rents, or profits of property subject to a security interest existing before or after the petition date. *Id.* Additionally, cash collateral includes “fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties.” *Id.* It should be noted that inventory and accounts receivable are not otherwise included in the definition of cash collateral.

Section 363(c)(2) permits *ex parte* authorization to use cash collateral in rare circumstances where there may not be time for a hearing, *i.e.*, in a situation where the debtor must use cash to preserve perishable goods.

### c. Asset Sales

Section 363 governs all sales of a debtor’s assets (other than those pursuant to a plan of reorganization under Section 1129)<sup>44</sup> regardless of the size of the asset to be sold (so-called “363 Sales”). Thus, this Section applies both in the context of a sale of a single asset as well as a sale of substantially all of the assets of a business.

Given the underlying bankruptcy purpose of maximizing the value of the estate assets, 363 Sales are typically undertaken through a public auction process. As a first step in this process, the trustee generally will attempt to find a bidder to set the floor value and opening bid for the asset (a so-called “stalking horse” bidder). Once a stalking horse bidder has been located and a purchase agreement agreed to (or, in the absence of a stalking horse bidder, once the asset is ready to be marketed for sale), the trustee will submit a motion to approve various procedures to govern the sale process. Where a stalking horse bidder is involved, such bid procedures typically include various bid protections, such as breakup fees, topping fees, expense reimbursements, minimum overbid increments, bidder qualifications, or no-shop clauses that restrict a trustee’s ability to market the asset. These are included in order to compensate the stalking horse bidder for the expense and risks associated with assuming such role.

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<sup>44</sup> Section 1129 of the Bankruptcy Code is discussed in greater detail in Chapters VI.F. and VI.G. below.

Courts have adopted varying standards for approving specific bidding procedures, such as breakup or topping fees. First and foremost, a court will determine whether the procedures maximize the asset's sale price. See *In re Mushroom Transp. Co.*, 382 F.3d 325, 339 (3d Cir. 2004). Additionally, courts will consider whether the fee is reasonable, made in good faith, encourages higher bids and is generally beneficial to creditors and equity holders. See *In re Integrated Resources Inc.*, 147 B.R. 650, 657 (Bankr. S.D.N.Y. 1992); see *United States Trustee v. Bethlehem Steel Corp. (In re Bethlehem Steel Corp.)*, No. 02 Civ. 2854, 2003 U.S. Dist. LEXIS 12909 (S.D.N.Y. July 23, 2003). Courts also evaluate a breakup fee in the context of Section 503(b)(1)(A) and require that the trustee demonstrate that the breakup fee is a necessary expense to preserve the value of the estate. See *In re O'Brien*, 181 F.3d 527, 535 (3rd Cir. 1999). Generally, courts have authorized breakup fees in the amount of one to four percent of the purchase price. See *Tama Beef Packing, Inc.*, 312 B.R. 192, 195 n.1 (Bankr. N.D. Iowa 2004) (listing cases).

As part of the bidding procedures, there will also typically be a period for the trustee to approach other parties (whether through direct communication or through public notification) who may be interested in purchasing the asset at issue and for such parties to undertake due diligence, which period begins upon the court's approval of the bidding procedures, and a deadline by which any additional bids for the asset must be submitted (the so-called "bid deadline"). If additional bids are received, the trustee will then hold an auction for the asset at which each of the competing bidders can increase their respective bids for the asset. At the conclusion of the auction, a winning bidder is selected and the trustee will seek court approval of the sale to the winning bidder.

Most courts agree that, within the context of a Chapter 11 reorganization, a debtor must show sound business judgment prior to engaging in a 363 Sale.<sup>45</sup> See *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1171 (2d Cir. 1983). In determining whether a 363 Sale is permitted, a court may consider: (i) the proportionate value of the asset to the estate as a whole; (ii) the amount of elapsed time since the filing; (iii) the likelihood that a plan of reorganization will be proposed and confirmed in the

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<sup>45</sup> For a discussion of the business judgment rule, see Chapter VI.C.2.

near future; (iv) the effect of the proposed disposition on future plans of reorganization; (v) the proceeds to be obtained from the disposition vis-à-vis any appraisals of the property; (vi) which of the alternatives of use, sale or lease the proposal envisions; and (vii) whether the asset is increasing or decreasing in value. *See id.*

Although, as noted above, the Bankruptcy Code does not limit the size or scope of a sale of the debtor's assets, under Section 363, where the sale is for all or substantially all of the debtor's assets, some courts have demonstrated hesitancy in approving the sale because of the view that such sale has the affect of a plan of reorganization, but without the procedural protections associated with the plan confirmation process. These so-called "*sub rosa*" plans are sometimes rejected by bankruptcy courts as mere attempts to fashion a reorganization through the parameters of a 363 Sale, thereby circumventing the Chapter 11 requirements of confirmation. *See In re Braniff Airways, Inc.*, 700 F.2d 935, 940 (5th Cir. 1983).<sup>46</sup>

However, in order to ease a debtor's ability to sell assets, Section 363(f) authorizes the trustee to sell property free and clear of a third party's interest when: (i) applicable nonbankruptcy law permits such a sale; (ii) the third party consents; (iii) the interest is a lien and the price for the property exceeds the value of all liens on the property; (iv) the interest is in bona fide dispute; or (v) the third party could be compelled in a legal or equitable proceeding to accept a money satisfaction of its interest. Courts have attempted to define the scope of "interest" for purposes of Section 363(f). Although some courts have limited the definition to an *in rem* interest in property (*see, e.g., Fairchild Aircraft, Inc. v. Cambell (In re Fairchild Aircraft Corp.)*, 184 B.R. 910 (Bankr. W.D. Tex. 1995)), most use a broader definition of the term that encompasses many other obligations that stem from ownership of the property. *See In re Trans World Airlines, Inc.*, 322 F.3d 283 (3rd Cir. 2003).

If the property to be sold is subject to a lien that secures an allowed claim, the holder of the claim may, unless the court orders otherwise, "credit bid" at the sale, offsetting the amount of its claim against the purchase price. 11 U.S.C. § 363(k). This is an important protection for a secured party whose

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<sup>46</sup> In *In re Braniff Airways, Inc.*, the court rejected a proposed 363 Sale primarily because the terms of the sale attempted to "dictat[e] some of the terms of any future reorganization plan." 700 F.2d 935, 940 (5th Cir. 1983). The court added that a debtor should not be able to evade the requirements of Chapter 11 confirmation "by establishing the terms of the plan *sub rosa* in connection with the sale of assets." *Id.*

collateral is being liquidated in a bankruptcy sale. The right to credit bid enables a lien holder to purchase assets without putting up any cash and retake the property when it believes that the price bid at the sale does not sufficiently reflect the value of the collateral.<sup>47</sup>

If property is jointly owned, it may be sold if: (i) partition is impractical; (ii) benefit to the estate outweighs the detriment to the other party; (iii) sale of only the estate's undivided interest would bring in substantially less than sale of the entire property; and (iv) it is not property used in the production or provision of gas or electric power. 11 U.S.C. § 363(i). A co-owner of jointly-owned property has a right of first refusal, but if such right is not exercised, the trustee must deliver to the co-owner its appropriate share of the proceeds. 11 U.S.C. § 363(j).

### 3. *Assumption and Rejection of Executory Contracts and Unexpired Leases*

Section 365 of the Bankruptcy Code provides the trustee or debtor-in-possession<sup>48</sup> with the authority to assume, assume and assign, or reject executory contracts and unexpired leases. The term “executory contract” is not defined in the Bankruptcy Code, but the prevailing definition of an executory contract, first expounded by Professor Vern Countryman of Harvard Law School in his article, *Executory Contracts in Bankruptcy, Part 1*, 57 Minn. L. Rev. 439, 460 (1973), is one where “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.” Similarly, the term “unexpired lease” is not defined in the Bankruptcy Code. However, courts have held

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<sup>47</sup> In addition to the right to credit bid in a sale undertaken outside of a plan of reorganization, Section 1129(b) also provides for this right where the plan contemplates a sale of assets and the secured creditors whose collateral are being sold are subject to “cramdown” under such plan. (For a discussion of cramdown, see Chapter VI.G.2.a. below.) However, the status of a lien holder's absolute right to “credit bid” in the plan scenario has been questioned by at least two U.S. Circuit Courts of Appeal. See *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3rd Cir. 2010); *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009).

<sup>48</sup> For purposes of the discussion on Section 365 of the Bankruptcy Code, as discussed in Chapter I.A., references to a “trustee” also encompass the debtor-in-possession in a Chapter 11 case.

that a “lease” for purposes of Section 365 refers to a “true lease” and not a disguised security agreement or financing arrangement. See *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609 (7th Cir. 2005). Additionally, an unexpired lease must be in effect at the time the petition is filed. See *In re Emilio Cavallini, Ltd.*, 112 B.R. 73, 76 (Bankr. S.D.N.Y. 1990).

#### a. Generally

An executory contract must be assumed or rejected in its entirety; a trustee or debtor-in-possession cannot assume parts of contracts and leases and reject other parts. *In re Adelpia Bus. Solutions, Inc.*, 322 B.R. 51, 54 (Bankr. S.D.N.Y. 2005). Furthermore, the assumption or rejection of an executory contract or an unexpired lease is subject to court approval. 11 U.S.C. § 365(a). Although, the Bankruptcy Code does not provide a standard for judicial review, most courts have applied a “business judgment” test to the decision to assume or reject contracts or leases, discussed in greater detail in Chapter VI.C.2. See *Regen Capital I, Inc. v. Halperin (In re U.S. Wireless Data, Inc.)*, 547 F.3d 484, 488 (2d Cir. 2008).

#### b. Assumption

Section 365(b) of the Bankruptcy Code provides the standards and procedures whereby a trustee may assume an executory contract or unexpired lease. Section 365(b) permits a trustee to basically choose which contracts it would like to continue to perform when it emerges from bankruptcy (*i.e.*, the contracts it finds most beneficial to the estate).

According to Section 365(b) of the Bankruptcy Code, a trustee may not assume an executory contract or lease on which there has been a default unless the trustee: (i) cures the default or provides adequate assurance that the default will be promptly cured; (ii) compensates or provides adequate assurance that the trustee will promptly compensate the other party for any actual pecuniary loss to the party resulting from the default; and (iii) provides adequate assurance of future performance under the contract or lease. 11 U.S.C. § 365(b). Section 365(b)(1)(A) provides, however, that a trustee need not cure, prior to assumption, a nonmonetary default under an unexpired lease of nonresidential real property if it is impossible for the trustee to cure

such default at and after assumption, unless the default relates to a failure to operate in accordance with the lease. Furthermore, the cure requirements of Section 365 do not apply to defaults relating to the debtor's insolvency or financial condition or to penalty provisions triggered by nonmonetary defaults. 11 U.S.C. § 365(b)(2)(A)–(D).

### c. Rejection

If a trustee determines that assumption of an executory contract or unexpired lease is not in the debtor's best interest, it may instead decide to reject such contract or lease. If a contract or lease is rejected, such rejection is generally considered a prepetition breach, and the non-breaching party will obtain an unsecured claim for damages arising as a result of the breach. 11 U.S.C. § 365(g). However, rejection, under Section 365(g), is not deemed to cause a termination of the contract. *See, e.g., Doral Commerce Park, Ltd v. Teleglobe Commc'ns Corp. (In re Teleglobe Commc'ns Corp.)*, 304 B.R. 79 (D. Del. 2004).

Generally, damages resulting from the rejection of an unassumed executory contract or lease are calculated pursuant to the terms of the contract and the general law of contracts. However, in certain instances, the Bankruptcy Code provides caps on the amount of such damages (such as the so-called "502(b)(6) limitation" discussed in Chapter V.D.5.) where the nature and/or length of the contract or lease at issue would result in an extremely large rejection damage claim.

One exception to the rule that rejection damage claims constitute prepetition unsecured claims is where the contract subject to rejection had previously been assumed by the debtor. In such an instance, the breach arising from the rejection is deemed to have occurred at the time of such rejection and the concomitant claim will be deemed to be an administrative expense claim rather than a prepetition unsecured claim since the rejection will have occurred postpetition. 11 U.S.C. § 365(g)(2)(A); *see also Nostas Assocs. v. Costich (In re Klein Sleep Prods.)*, 78 F.3d 18, 26 (2d Cir. 1996). As discussed below in Chapter V.D.2.a, this can have significant consequences on

the debtor's ability to confirm a plan of reorganization.<sup>49</sup> As a result, as part of the 2005 Amendments, Congress capped the amount that can be awarded for a rejection damage claim in this context with respect to nonresidential real property leases (although not other leases or contracts). 11 U.S.C. § 503(b)(7).<sup>50</sup> The cap established by Section 503(b)(7) is an amount equal to all monetary obligations due for a period of two years following the later of the date of rejection of the lease or the date of actual turnover of the premises by the trustee to the lessor, but excluding any charges related to a failure by the trustee to operate the premises or any penalty provision contained in the lease and without reduction except for sums actually received or to be received from a party other than the debtor. *Id.*

The Bankruptcy Code provides important caveats to the right of a trustee to reject contracts. First, where the debtor is the lessor of real property and the lease is rejected, the Bankruptcy Code provides that the lessee may generally treat the lease as terminated by its own terms. 11 U.S.C. § 365(h)(1)(A)(i). Second, where the debtor is the lessor of real property and the lease term has already commenced, the lessee may, notwithstanding the trustee's rejection of the lease, retain its rights under such lease that are appurtenant<sup>51</sup> to the real property for the balance of the term of the lease and any renewal or extension rights. 11 U.S.C. § 365(h)(1)(A)(ii). Third, if an executory contract for the sale of real property is rejected when the purchaser is already in possession, the non-debtor purchaser may deem the contract terminated, or it may remain in possession and continue making payments due under the contract, less offsets for damages caused by the

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<sup>49</sup> This issue is especially relevant in the context of retail debtors who have a large number of nonresidential real property leases due to the short deadline by which the decision to assume or reject must be made (discussed in Chapter V.E.3.e. below). Such debtors must prioritize their analysis of which store leases to keep and to discard or else find themselves in the situation of mistakenly discarding valuable, performing stores in order to avoid the potential consequences of keeping an underperforming store or mistakenly keeping underperforming stores and then later having to discard them with the harsh impact this can have on determining the terms of a plan of reorganization.

<sup>50</sup> Damages in excess of this amount would be general unsecured claims subject to the cap in Section 502(b)(6) described above.

<sup>51</sup> The Bankruptcy Code provides non-exclusive examples of rights appurtenant to the real property, such as rights concerning the timing and payment of rent, quiet enjoyment, and rights to assign, sublease and hypothecate. 11 U.S.C. § 365(h)(1)(A)(ii).

debtor's non-performance. 11 U.S.C. § 365(i). In such a case, the trustee must deliver title to the purchaser in accordance with the provisions of the contract, but is relieved of all other obligations to perform under the contract. 11 U.S.C. § 365(i)(2)(B). If a non-debtor purchaser deems the contract terminated (or if such a purchase contract is rejected where the purchaser is not in possession), it is granted a lien on the property for any portion of the purchase price already paid. 11 U.S.C. § 365(j). Fourth, if a debtor is the licensor of a right to intellectual property<sup>52</sup> and rejects the license, the licensee may treat the contract as terminated or it may retain its rights under the contract to such intellectual property as those rights existed prepetition. 11 U.S.C. § 365(n).

#### d. Assumption and Assignment

In certain instances, a trustee may determine that an executory contract or unexpired lease is advantageous but that the trustee is unable to perform the contract or lease or believes the sale of such contract or lease would be more beneficial. In such an instance, a trustee may assume the contract pursuant to the rules discussed above and then assign it through a sale to a third party. An executory contract or unexpired lease can be assigned pursuant to Section 365(f) notwithstanding a provision in the contract or lease or applicable law that may prohibit the assignment of such contract or lease. 11 U.S.C. § 365(f)(1). To assign an executory contract or unexpired lease, a trustee must comply with the provisions for assuming an executory contract or unexpired lease and provide adequate assurance of future performance. 11 U.S.C. § 365(f)(2). This is due to the fact that Section 365(k) provides that assignment relieves the trustee and the estate from any liability for breaches occurring after the assignment. Moreover, an executory contract or unexpired lease can be assigned notwithstanding language in the contract or lease that would terminate or modify the agreement due to an assignment. 11 U.S.C. § 365(f)(3).

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<sup>52</sup> Section 101(35A) of the Bankruptcy Code defines "intellectual property" as a (i) trade secret; (ii) invention process, design, or plant protected under title 35; (iii) patent application; (iv) plant variety; (v) work of authorship protected under title 17; or (vi) mask work protected under chapter 9 of title 17. Notably, this definition excludes trademarks.



However, Section 365(c) provides that assumption or assignment is prohibited when: (i) nonbankruptcy law allows the non-debtor party to refuse performance from or refuse to perform for a party other than the debtor (*i.e.*, a personal services contract) and the non-debtor party does not consent to such assumption or assignment; (ii) the contract is an agreement to provide a loan, debt financing or other financial accommodation to, or for the benefit of, the debtor, or to issue a security of a debtor; or (iii) the contract is a lease of nonresidential property that has been terminated before the bankruptcy filing.

Thus, Section 365(c) prohibits a trustee from assuming or assigning an executory contract if “applicable law excuses a party . . . from accepting performance from . . . an entity other than the debtor or the debtor-in-possession,” whereas Section 365(f) states that notwithstanding applicable law that restricts or conditions assignment of an executory contract, the trustee may assign such contract. To rectify this incongruence, courts have utilized two approaches in determining whether an executory contract can be assumed. One approach applies the *hypothetical test*, which presumes that the trustee intends to assign the contract even if in reality it does not, and then bars assumption of the executory contract if applicable law would prohibit assignment. See *Cinicola v. Scharffenberger*, 248 F.3d 110, 126 n.19 (3d Cir. 2001). The second approach applies the *actual test*, which bars assumption only when the trustee actually intends to assign the executory contract and applicable law prohibits such an assignment. See *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 619 (1st Cir. 1995).

#### e. Miscellaneous

In a case filed under Chapter 7 of the Bankruptcy Code, the trustee must assume or reject an executory contract or unexpired lease of residential real property or personal property within sixty days after the order for relief (or within such additional time granted by the court), or the contract or lease will be deemed rejected. 11 U.S.C. § 365(d)(1). In a Chapter 9, 11, 12 or 13 case, an executory contract or unexpired lease of residential real property or personal property may be assumed or rejected any time before a plan of reorganization is confirmed. 11 U.S.C. § 365(d)(2). However, in such a case, a party in interest may request that the court establish a shorter time period in which these actions must occur. *Id.* Furthermore, Section

365(d)(4) of the Bankruptcy Code provides that nonresidential real property leases, under which the debtor is the lessee, will be deemed rejected if the lease is not assumed or rejected by the trustee before the earlier of (i) the 120<sup>th</sup> day after the date of the order for relief—subject to a one-time extension of up to ninety days for cause,<sup>53</sup> or (ii) the date a Chapter 11 plan of reorganization is confirmed.

Sections 365(d)(3) and 365(d)(5) also require that the trustee perform certain obligations arising under leases for both nonresidential real property as well as personal property pending their assumption or rejection. According to Section 365(d)(3), the trustee must perform virtually all of the obligations of a debtor arising from and after the order for relief under a lease of nonresidential real property, provided that the court may, upon a showing of cause, extend the deadline for performance of any such obligation, but subject to the limitation that any obligation that arises within the first sixty days after the date of the order for relief must be performed within such sixty day period.

Section 365(d)(5), which, unlike Section 365(d)(3), is limited to cases filed under Chapter 11 of the Bankruptcy Code, provides similar requirements for a debtor's obligations arising under an unexpired commercial personal property lease beginning sixty days after the order for relief. The court may, however, modify the performance required (or the timing thereof) under Section 365(d)(5) based on the "equities of the case." 11 U.S.C. § 365(d)(5).

Finally, it is not uncommon for contracts and leases to include events of default based on a party's filing for bankruptcy (or similar action), insolvency or financial condition. Although such provisions, commonly referred to as "*ipso facto*" clauses, may still have some legal effect, pursuant to Section 365(e) of the Bankruptcy Code, they cannot act as a basis for terminating or modifying the agreement. Section 365(e)(2), however, provides exceptions to this rule, including where (i) nonbankruptcy law allows the non-debtor party to refuse performance from or refuse to perform for a party other than the debtor (*i.e.*, a personal services agreement) and the non-debtor party does not

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<sup>53</sup> Pursuant to Section 365(d)(4)(B)(ii), subsequent extensions may be granted only upon prior written consent of the lessor.

consent to assumption or assignment of the contract or (ii) the contract is an agreement to provide a loan, debt financing or other financial accommodation to, or for the benefit of, the debtor, or to issue a security of the debtor.

#### 4. *Obtaining Postpetition Credit*

Given the poor financial condition facing most debtors, one of the most pressing issues that must be addressed when preparing for a bankruptcy filing is the source and terms of adequate working capital to permit the debtor to operate its business during a bankruptcy proceeding and to pay the costs of such proceeding. In order to provide guidance to both debtors and prospective lenders in this regard, in addition to the provisions of Section 363 governing the use of cash collateral, which is discussed in Chapter V.E.2.b., Section 364 of the Bankruptcy Code authorizes a trustee to borrow funds to assist it during the bankruptcy process. The terms on which such funds can be borrowed, as well as the required level of court approval, depend in part on the level of seniority provided to the lenders. For example, a trustee or debtor-in-possession can obtain unsecured credit and incur unsecured debt allowable as a first priority administrative expense under Section 503(b)(1). 11 U.S.C. § 364(a)–(b). Whether court approval is necessary depends on whether or not the incurrence of such debt is in the ordinary course of the debtor’s business. *Id.*

If a trustee or debtor-in-possession is unable to obtain unsecured credit pursuant to Section 364(a) or (b) of the Bankruptcy Code, the court, after notice and hearing, may authorize the trustee to obtain credit or incur debt: (i) with priority over other administrative expenses (a “super priority claim”); (ii) secured by a lien on unencumbered property of the estate; or (iii) secured by a junior lien on property of the estate that is already subject to a lien. 11 U.S.C. § 364(c). Additionally, if a trustee or debtor-in-possession cannot obtain credit under any of the foregoing provisions, the court may authorize the trustee or debtor-in-possession to obtain credit or incur debt secured by a senior or equal lien on property of the estate that is already encumbered. Such lien (a “priming lien”) can only be authorized if: (i) the trustee is unable to obtain such credit otherwise and (ii) the existing lien holder is provided adequate protection of its interest in the collateral at issue. 11 U.S.C. § 364(d). Because of the need under certain of the provisions of Section 364

to demonstrate that credit was not otherwise available on better terms, a debtor must often seek to obtain multiple offers for financing from the market before seeking court approval.

Section 364(e) of the Bankruptcy Code provides protection to a lender that provided the credit in good faith. If court authorization to obtain credit or incur debt is reversed or modified on appeal, the appeal will not affect the validity of any debt incurred or lien or priority granted under Section 364 as long as the lender acted in good faith. It does not matter whether or not the lender knew of the pending appeal as long as it acted in good faith.

The court may not schedule a hearing on a motion seeking authorization to obtain credit earlier than fifteen days after the motion is served, provided that an interim hearing authorizing emergency funding to avoid immediate and irreparable harm may be held before fifteen days have passed. Fed. R. Bankr. P. 4001(c)(2).

### *5. Utility Service*

Section 366 of the Bankruptcy Code requires a utility to continue to provide service to the debtor for at least a short period of time after a bankruptcy case has commenced. Upon the twentieth day following the commencement of a case, other than one filed under Chapter 11, however, a utility provider can alter, refuse, or discontinue service if it is not furnished with “adequate assurance” of payment in the form of a deposit or other security. 11 U.S.C. § 366(b). In addition, Section 366(c) governs utility providers in cases filed under Chapter 11 of the Bankruptcy Code. Such utility providers may alter, refuse, or discontinue service if they do not receive “adequate assurance” that is satisfactory to them during the thirty-day period beginning on the petition date. Under Section 366(c)(1)(A), “adequate assurance” is defined as a cash deposit, a letter of credit, a certificate of deposit, a surety bond, a prepayment of utility consumption, or another form of security that is mutually agreed upon between the utility and the debtor or the trustee. Additionally, a utility may set off against or recover a debtor’s prepetition security deposit without violating the automatic stay. 11 U.S.C. § 366(c)(4).

On request of a party and after notice and a hearing, the court may modify the amount of adequate assurance demanded by the utility. 11 U.S.C. § 366(b)–(c)(3)(A). In determining whether an assurance of payment is adequate in a case filed under Chapter 11, a court may *not* consider: (i) the absence of security before the petition date; (ii) the payment by the debtor for utility service in a timely manner before the petition date; or (iii) the availability of an administrative expense priority. 11 U.S.C. § 366(c)(3)(B).

## 6. Power of the Court

According to the Bankruptcy Code, the court may issue any “order, process, or judgment necessary or appropriate” to carry out other provisions of the Bankruptcy Code. 11 U.S.C. § 105(a). Historically, practitioners have sought to use Section 105(a) as a basis for approval of requests for relief that may not be squarely authorized by the Bankruptcy Code, and many courts permitted Section 105(a) to be used in this fashion. More recently, however, courts have begun to restrict the use of Section 105(a) by requiring that the requested relief have a more solid basis in the Bankruptcy Code.

One prime example of the use of Section 105(a) is as a basis for a stay or injunction where the automatic stay may not be applicable. Injunctions and stays issued under Section 105 of the Bankruptcy Code are governed by the standard rules and procedures applying to injunctions generally. These require the court to consider some or all of the following: (i) whether the movant has demonstrated a probability of success on the merits; (ii) whether there is a clear showing of the threat of irreparable harm to the movant in the absence of the injunction; (iii) whether the injunction would result in substantial harm to others; and (iv) whether the injunction is in the public interest. *See, e.g., W.R. Grace & Co. v. Libby Claimants*, No. 08–246, 2008 U.S. Dist. LEXIS 86958 (D. Del. Oct. 28, 2008) (citing *Hilton v. Braunskill*, 481 U.S. 770, 776 (1987)).

Another example of relief commonly sought under Section 105(a) is for payments made to creditors on account of prepetition claims, including where such claims would be entitled to a level of priority (*e.g.*, accrued but unpaid prepetition wages) as well as so-called “critical vendor” payments. Whereas the payment of the former category of claims generally continues to be authorized, payment of the latter category is subject to more scrutiny. Courts generally require that the following three conditions are met before issuing a critical vendor order. First, non-critical vendors and other unsecured

creditors are not made worse off because of the payment. Second, alleged critical vendors will cease deliveries if old debts go unpaid. Third, there are no alternatives to appease critical vendors in order to receive future deliveries. See *In re Kmart Corp.*, 359 F.3d 866, 871 (7th Cir. 2004).

Pursuant to Section 105, the court must also hold status conferences to foster efficient resolution of the case, during which it may fix dates for various Chapter 11 matters where otherwise permitted by the Bankruptcy Code. 11 U.S.C. § 105(d).

Although the court's power under Section 105 of the Bankruptcy Code is broad, the court cannot ignore or suspend other provisions of the Bankruptcy Code. See *New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc.* (*In re Dairy Mart Convenience Stores, Inc.*) 351 F.3d 86 (2d Cir. 2003). For example, Section 105 does not allow the bankruptcy court to breathe life into contractual agreements that have expired by their own terms, or expand upon agreements incorporated into a plan. *In re SPM Mfg. Corp.*, 984 F.2d 1305, 1311 (1st Cir. 1993). Moreover, Section 105 cannot be used to require adequate protection for an unsecured claim. See *In re Dairy Mart Convenience Stores*, 351 F.3d 86.

## F. Augmentation of the Estate

As noted above, one of the underlying principles of the Bankruptcy Code is to maximize the assets of the estate so as to increase the distribution to creditors and interest holders. In order to aid in this endeavor, the Bankruptcy Code provides a trustee or a debtor-in-possession with the power to undo or “avoid” a broad range of pre- and postpetition transactions and to recover for the estate the property transferred by the debtor pursuant to such transactions.<sup>54</sup> As this can occur in a variety of ways, there are a number of so called “avoidance actions” under the Bankruptcy Code.<sup>55</sup> Additionally, a

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<sup>54</sup> For purposes of the discussion of the augmentation of an estate, in a Chapter 11 case, references to a “trustee” also encompass a debtor-in-possession.

<sup>55</sup> In addition to the avoidance actions created by the Bankruptcy Code, State law also contains similar actions. As will be discussed below, a trustee or debtor-in-possession can also utilize the State law causes of action to collect assets in a bankruptcy proceeding. Generally, these State law actions include the provisions of the Uniform Fraudulent Transfer Act (enacted by forty-four jurisdictions) and the Uniform Fraudulent Conveyance Act (enacted by four jurisdictions).

creditors' committee possesses standing to exercise the avoidance powers on behalf of the estate when the debtor-in-possession grants the committee such right or refuses to exercise its avoidance powers. See, e.g., *In re STN Enters., Inc.*, 779 F.2d 901, 904 (2d Cir. 1985); *The Official Committee of Unsecured Creditors on behalf of Cybergenetics Corp. v. Chinery*, 330 F.3d 548 (3rd Cir. 2003), cert. denied 124 S.Ct. 530 (2003).

### 1. Preferences

Preferences are prepetition transfers in which a debtor transfers property to creditors within a specified time period prior to its bankruptcy filing, with the result that such creditors, if they were entitled to retain the property transferred to them, would receive a better percentage recovery on account of their prepetition claims than creditors who did not receive similar payments. As a result of this difference in recoveries, the Bankruptcy Code provides the trustee or the debtor-in-possession with the power to avoid preferential transfers. 11 U.S.C. § 547. Section 547(b) of the Bankruptcy Code defines an avoidable preference as “any transfer of an interest of the debtor in property”<sup>56</sup> (i) to or for the benefit of a creditor, (ii) on account of an antecedent debt (that is, one owed before the time of the transfer), (iii) made while the debtor was insolvent,<sup>57</sup> (iv) made to an insider within one year prior to the petition date, or to anyone else within ninety days prior to the filing date, and (v) that enables a creditor to receive more than it would have received in a distribution under Chapter 7 of the Bankruptcy Code. According to Section 547(f), a debtor is presumed to have been insolvent on and during the ninety days immediately preceding the petition date. Further, Section 547(i) provides that if the trustee avoids a transfer made between ninety days and one year before the petition date by the debtor to an entity that is not an insider for the benefit of an insider, such transfer shall be avoidable only with respect to the creditor that is an insider.

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<sup>56</sup> Generally, preferences include the transfer of cash or the granting of a lien on property of the debtor.

<sup>57</sup> Under Section 101(32) of the Bankruptcy Code, insolvency is defined by reference to a debtor's assets and liabilities and is sometimes referred to as a “modified” balance sheet test in that while it refers to the items contained in a balance sheet, it does not follow Generally Accepted Accounting Principles when valuing such items. For a complete discussion of the term “insolvent,” see Chapter IV.3. above.

If all the elements of Section 547(b) are satisfied, the trustee may seek to avoid such transfer unless the transferee can prove that it is entitled to rely on one of the affirmative defenses listed in Section 547(c). Pursuant to Section 547(c), exempted transfers include the following:

- (i) transfers that were intended by the debtor and the creditor to be contemporaneous exchanges for new value<sup>58</sup> to the debtor and that were in fact “substantially contemporaneous” exchanges;
- (ii) payments of debts arising in the ordinary course of the debtor’s and the transferee’s business or financial affairs and which were made in the ordinary course of the debtor’s and the transferee’s business or financial affairs or according to ordinary business terms;
- (iii) grants of a security interest for enabling or purchase money loans where the creditor perfects its security interest within thirty days after receipt of the property by the debtor;
- (iv) transfers to the extent that the transferee gives new value to or for the benefit of the debtor on an unsecured basis after receiving a preferential transfer and on account of which the debtor did not make an otherwise unavoidable transfer to or for the benefit of the creditor;
- (v) transfers that create a perfected security interest in inventory or accounts receivable (a “floating lien”), except for any amount by which a creditor’s position improved on the petition date compared to its position on the later of the ninetieth day prior to the petition date<sup>59</sup> and the date on which new value was first given under the security agreement creating the security interest;

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<sup>58</sup> The Bankruptcy Code defines “new value” as money’s worth in goods, services or new credit, but not substitution of an old obligation with a new one. 11 U.S.C. § 547(a)(2).

<sup>59</sup> This becomes one year prior to the petition date if the creditor is an insider of the debtor. 11 U.S.C. § 547(c)(5)(A)(ii).



- (vi) transfers that fix a statutory lien that is not avoidable under Section 545 of the Bankruptcy Code;<sup>60</sup>
- (vii) bona fide payments of domestic support obligations;
- (viii) *de minimus* transfers by an individual debtor with primarily consumer debts;<sup>61</sup> and
- (ix) *de minimus* transfers by a debtor whose debts are not primarily consumer debts.<sup>62</sup>

Additionally, if a third party makes a transfer to a debtor to specifically enable the debtor to satisfy a claim of a designated creditor, such transfer does not become “an interest of the debtor” and is not subject to Section 547. This exception or defense is known as the “earmarking doctrine,” as the transfer is “earmarked” for a specific purpose and does not truly become “an interest of the debtor.” Courts have established a three-part test for determining whether a transaction qualifies for the earmarking doctrine. First, a court will determine whether the third party and the debtor have agreed that the new funds will be used to pay a specified antecedent debt. Second, a court will determine whether the agreement governing the transfer has actually been performed according to its terms. And, third, a court will view the transaction as a whole and must find that it does not result in any diminution of the estate. *See In re Bohlen Enters., Ltd.*, 859 F.2d 561, 565 (8th Cir. 1988).

The trustee or debtor-in-possession has the burden of proof for establishing the elements of a preference under Section 547(b), and the party against whom a preference action has been brought has the burden of proof for establishing the existence of the various defenses under Section 547(c). 11 U.S.C. § 547(g).

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<sup>60</sup> For a discussion of Section 545, see Chapter V.F.5.

<sup>61</sup> Under this defense, the aggregate value of all property transferred pursuant to, or affected by, a particular transfer must be less than \$600. 11 U.S.C. § 547(c)(8).

<sup>62</sup> Under this defense, the aggregate value of all property transferred pursuant to, or affected by, a particular transfer must be less than \$5,850. 11 U.S.C. § 547(c)(9).

Section 547(e) of the Bankruptcy Code sets forth certain timing provisions applicable to the avoidance of preferential transfers (*i.e.*, establishing when a transfer is deemed to occur for preference purposes). This is critical since a transfer is only preferential (and therefore subject to avoidance under this Section) if the transfer occurs after the incurrence of the obligation by the debtor. A transfer is deemed made (i) at the time of the transfer if such transfer is perfected at, or within thirty days after, such time (the “Thirty-Day Grace Period”); (ii) at the time such transfer is perfected, if such transfer is perfected after the Thirty-Day Grace Period; or (iii) immediately before the date of the filing of the petition if such transfer is not perfected at the later of the commencement of the case or thirty days after such transfer takes effect. Furthermore, a transfer cannot be made for preference purposes before the debtor has acquired rights in the property transferred.

Thus, the timing of a transfer depends on the time when such transfer was perfected. The determination of when a transfer is perfected depends entirely on applicable nonbankruptcy law. *See Barnhill v. Johnson*, 503 U.S. 393 (1992). Real property transfers (other than transfers of fixtures) are perfected when the transfer would be invulnerable to attack by a bona fide purchaser. 11 U.S.C. § 547(e)(1)(A). However, transactions relating to personal property or fixtures are perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee. 11 U.S.C. § 547(e)(1)(B). This generally occurs when a Uniform Commercial Code (UCC) financing statement is filed. A cash payment by a debtor to a creditor or an actual delivery of tangible personal property are perfected as soon as such transactions are made because, at that point, they are also perfected against subsequent judicial liens obtainable against the debtor. 11 U.S.C. § 547(e)(2).

## 2. *Fraudulent Conveyances*

Fraudulent transfers are prepetition transfers made or obligations incurred in which the value of the property transferred or the amount of the obligation incurred by the debtor is greater (by more than a minimal amount) than the value of the consideration received by the debtor in exchange for such property or obligation, either as a result of a concerted scheme by the debtor

to defraud its creditors or simply as a result of the facts and circumstances of the transfer or obligation. As such transfers or obligations result in diminishment of the estate, Section 548 of the Bankruptcy Code grants a trustee the power to avoid such transactions.

According to the Bankruptcy Code, transfers and obligations may be avoided as fraudulent transfers if they were made or incurred within two years before the petition date and (i) were “actually fraudulent” in that they were made or incurred with the actual intent to hinder, delay or defraud the debtor’s creditors or (ii) were “constructively fraudulent” in that they were made or incurred for less than reasonably equivalent value and the debtor (a) was insolvent at the time of, or became insolvent as a result of, the transfer or obligation,<sup>63</sup> (b) was engaged in or about to engage in business for which it was undercapitalized, (c) intended to or believed it would incur debts beyond its ability to pay when due, or (d) made such transfers to or for the benefit of an insider under an employment contract and not in the ordinary course of business. 11 U.S.C. § 548(a)(1).

A finding of constructive fraud hinges on the definition of “reasonably equivalent value” and a determination of the timing of the transfer in question. According to Section 548(d)(2), “‘value’ means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor.” Thus, determining whether the value received is reasonably equivalent to the value transferred is a fact-intensive analysis. See *Forman v. Jeffrey Matthews Fin. Group, LLC (In re Halpert & Co.)*, 254 B.R. 104, 115 (Bankr. D. N.J. 1999); *In re Roco Corp.*, 701 F.2d 978, 981-82 (1st Cir. 1983). The focus of the analysis is whether the exchange resulted in the preservation of assets for the benefit of the debtor’s creditors. See *Frontier Bank v. Brown (In re Northern Merchandise, Inc.)*, 371 F.3d 1056, 1059 (9th Cir. 2009). It is therefore only material whether the debtor lost value or failed to receive equal value in the exchange, as such a transfer would deleteriously affect the debtor’s creditors. See *id.* Furthermore, the debtor, and not some other entity, must receive the value. Also, for purposes of Section 548, a

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<sup>63</sup> The test for insolvency in Section 548 is the “modified” balance sheet test discussed above in footnote 57.

transfer occurs (i) when it is perfected so that it would be invulnerable to attack by a bona fide purchaser or (ii) just prior to the bankruptcy filing if not so perfected before commencement of the case. 11 U.S.C. § 548(d)(1).

Moreover, the Bankruptcy Code provides a special provision governing the avoidance of transfers of partnership property. Section 548(b) provides that transfers by a debtor partnership to a general partner within two years of the bankruptcy filing may be avoided regardless of reasonably equivalent value if the debtor was insolvent at the time of the transfer or obligation or became so as a result of the transaction. 11 U.S.C. § 548(b)

Additionally, Section 548(c) protects certain transferees by providing an exception to the voidability of fraudulent transfers for transferees that accept property from the debtor in exchange for “value and in good faith.” As stated above, “value” is defined according to Section 548(d)(2). The good faith prong of Section 548(c) requires: (i) an arm’s length transaction; (ii) an honest belief in the propriety of the activities in question; (iii) no intent to take unconscionable advantage of others; and (iv) no intent to, or knowledge of the fact that the activities in question will, hinder, delay or defraud others. See *Hirsch v. Cahill (In re Colonial Realty Co.)*, 210 B.R. 921 (Bankr. D. Conn. 1997).

There are also special provisions for qualified financial contracts which insulate certain transfers from attack as constructively fraudulent as discussed in more detail in Chapter V.G.1.

### 3. *Strong-Arm Powers of the Trustee*

Section 544 of the Bankruptcy Code grants the trustee the rights that certain creditors (whether in existence or not) would have under applicable State law to attack prior unperfected or unrecorded transfers. This power is referred to as the “strong arm” power and gives the trustee the status of a hypothetical lien creditor. 11 U.S.C. § 544(a). The trustee’s strong arm power acts to cut off unperfected security interests, secret liens and undisclosed prepetition claims against the debtor’s property as of the commencement of the case. Thus, the trustee holds the rights and powers to avoid transfers that could have been exercised by (i) a hypothetical creditor that obtained a judicial lien as of the commencement of the case; (ii) a

hypothetical creditor that had an execution returned unsatisfied as of the commencement of the case; or (iii) a hypothetical bona fide purchaser of real property who had perfected its interest as of the commencement of the case. 11 U.S.C. § 544(a).

Section 544(b) also permits a trustee to avoid any transfer or obligation that is avoidable under applicable law by an actual creditor holding an allowable unsecured claim. Such a creditor must actually exist but need not have reduced its claim to judgment or have executed upon it. However, the trustee acquires only those rights actually possessed by the creditor. Thus, if the creditor is estopped from attacking a transfer or the statute of limitations has run before the filing, the trustee is also barred.

Section 544(b) can be employed to utilize State fraudulent transfer laws, which are generally based on the Uniform Fraudulent Conveyance Act (UFCA) and the Uniform Fraudulent Transfer Act (UFTA). Although not exactly the same as the Bankruptcy Code fraudulent transfer provision, the UFCA and UFTA are similar to the Bankruptcy Code in most respects. However, State fraudulent transfer law is often preferred to the Bankruptcy Code's fraudulent transfer provision because the States generally provide a much longer statute of limitations. For instance, although Section 548 permits a trustee to avoid transfers that occurred within two years of the bankruptcy, Pennsylvania and Delaware provide a four year statute of limitation for actions to avoid fraudulent transfers, and New York provides a six year statute of limitation to avoid such transfers.

#### *4. Postpetition Transactions*

The trustee is authorized to avoid a postpetition transfer of property of the estate that is (i) authorized only under Section 303(f) or 542(c) of the Bankruptcy Code or (ii) not authorized under the Bankruptcy Code or by the court. 11 U.S.C. § 549(a).<sup>64</sup>

Notwithstanding the foregoing, some transfers that are authorized only under Section 303(f) or 542(c) of the Bankruptcy Code are protected from avoidance. For example, the trustee may not use Section 549(a) to avoid a

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<sup>64</sup> Section 303(f) refers to transactions that take place during the period between the filing of the petition and the entry of an order for relief in an involuntary bankruptcy case (the so-called "gap period"). Section 542(c) refers to transfers of estate property made by an entity lacking actual notice and actual knowledge of the commencement of the debtor's bankruptcy case.

transfer made during the gap period in an involuntary case to the extent that any postpetition value (excluding satisfaction of a prepetition debt) was given in exchange for such transfer, regardless of any notice or knowledge by the transferee of the case. 11 U.S.C. § 549(b); *see also In re Brooklyn Overall Co., Inc.*, 57 B.R. 999, 1002 (Bankr. E.D.N.Y. 1986). Moreover, the value provided need not be given prior to or simultaneously with the transfer of property so long as value is given during the gap period. 11 U.S.C. § 549(b); *see also In re Pucci Shoes, Inc.*, 120 F.3d 38, 41 (4th Cir. 1997).

Additionally, under Section 549(a), the trustee is not permitted to avoid a transfer of an interest in real estate that is perfected via recording to a good faith purchaser who lacked knowledge of the commencement of the case, and which was for present fair equivalent value, unless a copy or notice of the bankruptcy petition was filed with the applicable real estate recording office prior to perfection of such transfer. 11 U.S.C. § 549(c). A good faith purchaser without knowledge of the commencement of the case that acquired an interest in real estate for less than present fair equivalent value holds a lien on the property transferred to the extent of the value provided unless a copy or notice of the bankruptcy petition was filed with the applicable real estate recording office prior to the perfection of the transfer. *Id.* Also, courts have generally been loath to read Section 549(c) too broadly. *See, e.g., In re Miller*, 454 F.3d 899, 902 (8th Cir. 2006) (citing *Ford v. A.C. Loftin (In re Ford)*, 296 B.R. 537, 553 (Bankr. N.D. Ga. 2003) (“[T]he use of ‘present fair’ indicates an intent [by Congress] that *the protection of § 549(c) be limited to truly innocent purchasers who have actually paid a fair price in the transaction.*”) (emphasis added)).

Finally, Rule 6001 of the Bankruptcy Rules provides that “[a]ny entity asserting the validity of a transfer under [Section] 549 shall have the burden of proof.” In most cases, a proceeding to contest a transfer under Section 549 will be brought by the trustee or debtor-in-possession. Such proceeding, however, may not be commenced after the earlier of (i) two years after the date of the transfer sought to be avoided or (ii) the time the case is closed. 11 U.S.C. § 549(d).

## 5. Statutory Liens

Section 545 of the Bankruptcy Code authorizes the trustee to avoid the fixing of a statutory lien<sup>65</sup> on property of the debtor to the extent that such lien:

- (i) first becomes effective against the debtor upon the bankruptcy or insolvency of the debtor or the occurrence of an insolvency-like event with respect to the debtor;
- (ii) is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property, whether or not such purchaser exists (except with respect to certain tax liens);
- (iii) is for rent; or
- (iv) is a lien of distress for rent.

11 U.S.C. § 545. Two examples of statutory liens are mechanic's liens and tax liens. The trustee's avoidance powers under Section 545 do not extend to consensual or judicial liens.

Although the Bankruptcy Code does not define “fixing of a statutory lien,” the U.S. Supreme Court has observed (albeit with respect to a different Section of the Bankruptcy Code) that “[t]he gerund ‘fixing’ refers to a temporal event. That event—the fastening of a liability—presupposes an object onto which the liability can fasten . . . . Therefore, unless the debtor had the property interest to which the lien attached at some point before the lien attached to that interest, he or she cannot avoid the fixing of the lien . . . .” *Farrey v. Sanderfoot*, 500 U.S. 291, 296 (1991). It is also worth noting that, with respect to clause (i) in the preceding paragraph, the trustee only has the power to avoid so-called “springing liens” that arise because of or due to the debtor's insolvency. Section 545 “is not satisfied simply because a statutory

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<sup>65</sup> The Bankruptcy Code defines a “statutory lien” as a “lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute.” 11 U.S.C. § 101(53).

lien attaches to the debtor's property when she is insolvent or after the occurrence of other events described" in clause (i) above. *In re Swafford*, 160 B.R. 246, 248 (Bankr. N.D. Ga. 1993) (internal citation omitted). Additionally, payments made during the preference period to avoid fixing of statutory liens are not avoidable where perfection of the lien would not otherwise have been avoidable. See *Official Comm. of Unsecured Creditors of 360Networks (USA) Inc. v. AAF-McQuay, Inc. (In re 360Networks (USA) Inc.)*, 327 B.R. 187 (Bankr. S.D.N.Y. 2005).

## 6. Limitations on Avoidance

Section 546 of the Bankruptcy Code sets forth certain limitations on the ability of the trustee or debtor-in-possession to utilize its avoidance powers. According to Section 546(a) of the Bankruptcy Code, avoidance actions and actions commenced under certain other Sections of the Bankruptcy Code must be commenced within two years after the entry of the order for relief unless the case is closed before that time. However, if a trustee is appointed, the trustee must commence avoidance actions within one year of appointment of the initial trustee (as long as the two-year period had not expired before the appointment) unless the case is closed before that time. 11 U.S.C. § 546(a)(1).

Certain State laws allow perfection within a set period of time to relate back to the date on which an interest was created, which allows the holder of the security interest to defeat the rights of an intervening creditor. Section 546(b)(1) provides that the trustee's strong arm powers, power to avoid statutory liens, and power to avoid certain postpetition transactions may not interfere with this right where it extends into the postpetition time period. This Section also permits a secured creditor to take actions postpetition as necessary to continue or maintain a prepetition security interest. *Id.* Thus, for example, secured creditors are permitted to file UCC-3 continuation statements after the petition date.

Additionally, the trustee's powers under various of the avoidance actions are subject to a seller's right to demand the return of goods sold to the debtor in the ordinary course of the seller's business if the debtor received such goods



while insolvent, within the forty-five days prior to the petition date.<sup>66</sup> 11 U.S.C. § 546(c)(1). This right of reclamation is subordinate to a secured creditor that holds a prior lien on collateral or proceeds of such collateral. *Allegiance Healthcare Corp. v. Primary Healthy Sys. (In re Primary Health Sys.)*, 258 B.R. 111, 117 (Bankr. D. Del. 2001). To complete reclamation, the seller must provide written demand for reclamation of the goods within forty-five days after receipt of the goods by the debtor or twenty days after the petition date if the forty-five day period expires after the petition date. 11 U.S.C. § 546(c)(1). If the seller fails to provide such written notice, the seller may still assert an administrative expense claim for the value of any goods received by the debtor within twenty days before the commencement of the case pursuant to Section 503(b)(9). 11 U.S.C. § 546(c)(2).

Section 546 further provides that in Chapter 11 cases, with the seller's consent and subject to the prior rights of holders of security interests in goods shipped to the debtor prepetition, the court may order that such goods be returned to the seller and the seller may offset the purchase price against any prepetition claim of the seller against the debtor. 11 U.S.C. § 546(h). This right is contingent on the court's determination, on a motion of the trustee made within 120 days after the date of the order for relief, that a return of the goods is "in the best interests of the estate." *Id.* Finally, as discussed further below in Chapter V.G.1., Section 546 prohibits a trustee from avoiding certain transfers made to qualified persons under commodity contracts, forward contracts, securities contracts, swap agreements, repurchase agreements, and master netting agreements unless such transfers were actually fraudulent. 11 U.S.C. § 546(e), (f), (g), (j).

## 7. Turnover

A trustee may also use its turnover power to bring into the estate property in which the debtor did not have a possessory interest at the time the bankruptcy proceedings were commenced. 11 U.S.C. § 542. Section 542(a) requires that, subject to certain exceptions set forth below, all entities, other than custodians, having possession, custody or control of property that the trustee could use, sell or lease pursuant to Section 363, or that the debtor

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<sup>66</sup> The test for insolvency in Section 546 is the "modified" balance sheet test discussed above in footnote 57. This right of reclamation is derived from Section 2-702 of the UCC, which permits a seller to reclaim goods that a buyer has received on credit while insolvent if the seller discovers the buyer was insolvent when the seller provided the goods.

could exempt under Section 522, turn over that property to the trustee. The turnover power is self-executing and does not require the trustee to take any action or commence a proceeding or obtain a court order to compel turnover. See *Cornerstone Prods., Inc. v. Pilot Plastics, Inc. (In re Cornerstone Prods., Inc.)*, No. 05-53533, 2007 Bankr. LEXIS 4101 (Bankr. E.D. Tex. Dec. 5, 2007). The turnover power also reaches estate property that is in the hands of secured creditors, who are offered various rights to replace the protection afforded by possession of the property. *United States v. Whiting Pools*, 462 U.S. 198, 206 (1983).

Moreover, Section 542(b) requires that all entities that owe a debt to the debtor that is matured, payable on demand or payable on order turn over or pay that debt to the trustee or debtor-in-possession. A debt is “matured or payable on demand” if it is “presently payable,” and not “only payable upon the occurrence of some later event.” See *Kids World of Am., Inc. v. Georgia (In re Kids World of Am., Inc.)*, 349 B.R. 152, 163 (Bankr. W.D. Ky. 2006).

As noted above, Section 542 provides for certain exceptions to the turnover requirement. According to Section 542, a party need not return property or pay a debt where: (i) such property is of inconsequential value or benefit to the estate (11 U.S.C. § 542(a)); (ii) a party obligated on a debt to the debtor has a valid right of setoff (11 U.S.C. § 542(b)); (iii) a property holder lacks actual knowledge or notice of the bankruptcy filing and transfers the debtor’s property or pays a debt owing to the debtor in good faith to a party other than the trustee (11 U.S.C. § 542(c)); or (iv) the debtor’s property is automatically transferred to pay a life insurance premium (11 U.S.C. § 542(d)).

There is no statute of limitations on turnover claims, because such claims are equitable in nature and are subject to the doctrine of laches. See *Burtch v. Ganz (In re Mushroom Transp. Co.)*, 382 F.3d 325, 337 (3d Cir. 2004).

## 8. Recovery of Avoided Amounts

Although the avoidance powers described above permit a trustee or debtor-in-possession to undo certain transactions or obligations, they do not, in and of themselves, provide for the return of any property to the estate. Instead, this power is granted pursuant to Section 550 of the Bankruptcy Code. In particular, Section 550(a) grants the trustee the power to recover, for the benefit of the estate, the property transferred, or, if the court so orders,

the value of such property, from the initial transferee of an avoided transfer, the entity for whose benefit such avoided transfer was made, or any immediate or mediate transferee of such initial transferee.<sup>67</sup>

The trustee, however, may not recover the property or value from an immediate or mediate transferee of an initial transferee if such immediate or mediate transferee takes the property for value, in good faith, and without knowledge of the voidability of the transfer avoided (a so-called “good faith transferee”). 11 U.S.C. § 550(b)(1). The trustee is also prohibited from recovering property from any immediate or mediate good faith transferee of such a good faith transferee under Section 550(b)(1). 11 U.S.C. § 550(b)(2).

Certain types of transferees can assert different defenses to a trustee’s action to recover property. First, it is important to note that the “good faith” defense described in Section 550(b) does not apply to an initial transferee. Only immediate and mediate transferees of the initial transferee can assert the “good faith” defense. Some transferees, particularly financial institutions, have also argued that since they served as “mere conduits,” rather than as “transferees,” to a transfer, they should not be an entity from whom the trustee can recover property under Section 550. See, e.g., *In re Manhattan Investment Fund LTD.*, 359 B.R. 510 (Bankr. S.D.N.Y. 2007). According to these transferees, a “conduit” acts as a middle man between the debtor and an initial transferee, and, therefore, such entities have argued that recovery should only be sought from the initial transferees. As Judge Easterbrook articulated, “the minimum requirement of status as a ‘transferee’ is dominion over the money or other asset, the right to put the money to one’s own purposes. When A gives a check to B as agent for C, then C is the ‘initial transferee’; the agent may be disregarded.” *Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890, 893 (7th Cir. 1988). To distinguish between a conduit and a transferee, courts have applied a “dominion and control” test. See *In re Manhattan Investment Fund LTD.*, 359 B.R. 510. Factors that courts have considered in this context include: (i) the level of control the recipient had over the property; (ii) whether the recipient received consideration or compensation for the transfer; (iii) whether the recipient had any liability in the transaction; and (iv) whether the recipient held any security interest in the property transferred. See *id.*

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<sup>67</sup> However, a trustee can only recover the value of the property transferred; it cannot obtain multiple recoveries from initial and subsequent transferees. 11 U.S.C. § 550(d).

Section 550(e) also protects good faith transferees to the extent of the lesser of the cost of any improvement (*i.e.*, physical additions or changes to the property, repairs, payment of taxes on the property, payment of a debt secured by a lien on the property, discharge of a lien on the property, and preservation of the property) the transferee makes in the property less any profit to the transferee from such property, or any increase in value of the property as a result of the improvement. Courts have held that a good faith transferee must (i) take the property in an arm's length transaction; (ii) with an honest belief in the propriety of the activities in question; (iii) with no intent to take unconscionable advantage of others; and (iv) with no intent to, or knowledge of the fact that the activities in question will, hinder, delay, or defraud others. See *Hirsch v. Cahill (In re Colonial Realty Co.)*, 210 B.R. 921, 923 (Bankr. D. Conn. 1997).

Under Section 550(c), the trustee may not seek recovery from a transferee who is a non-insider creditor if the avoided transfer at issue was a preference that was made between 90 days and one year before the filing of the petition for the benefit of an insider creditor. Finally, according to Section 550(f) of the Bankruptcy Code, an action to recover avoided transfers must be brought no later than the earlier of one year after the transfer was avoided or the date the case is closed or dismissed.

Finally, it should be noted that whereas the fraudulent conveyance provision of the Bankruptcy Code (Section 548) speaks in terms of avoiding either transfers made or obligations incurred, Section 550, while applicable to Section 548, only refers to transfers avoided and not to obligations incurred.

## G. Special Exceptions

### 1. *Swap Agreements, Commodity and Securities Contracts, Forward Contracts, Repurchase Agreements and Master Netting Agreements*

#### a. Overview

As discussed above in Chapter V.E.3., one of the most important tools of a Chapter 11 reorganization is the trustee's or debtor-in-possession's ability to assume favorable executory contracts while rejecting those that are not. Generally, a trustee or a debtor-in-possession enjoys these powers notwithstanding the existence of contractual provisions known as *ipso facto* clauses that purport to give the non-bankrupt party the right to terminate the relevant contract upon the occurrence of certain bankruptcy- or insolvency-triggered defaults or termination events.<sup>68</sup> Additionally, as discussed above in Chapters V.C. and V.F., the bankruptcy estate benefits from the automatic stay of actions against the debtor or its property (including setoffs of prepetition debts), as well as certain avoidance provisions enabling the estate to avoid and recover prepetition preferences and fraudulent transfers. See 11 U.S.C. §§ 362, 547, 548.

In the case of derivative contracts, such as forward contracts, swaps, securities and commodities contracts and repurchase agreements and master netting agreements relating thereto (so-called "safe harbor contracts"), Congress created exceptions to these general rules in order to minimize volatility in the financial markets. Since the value of a derivative contract fluctuates with the market, derivative counterparties are at a special disadvantage if they are not able to terminate their contracts upon their counterparty's bankruptcy, but instead must await the trustee's decision to assume or reject the contract. Moreover, counterparties would face the risk that the trustee could "cherry-pick" among derivative transactions, treating each transaction under a master agreement as a separate executory contract, and assuming only those transactions that are "in the money" to the debtor, while rejecting those that are not. In light of these special risks, and the larger

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<sup>68</sup> *Ipso facto* clauses are provisions that terminate or modify the debtor's rights based on its financial condition, the filing of a bankruptcy or insolvency proceeding, or the appointment of a trustee or receiver. See 11 U.S.C. § 365(e)(1) (discussed above in Chapter V.E.3.e.).

systemic risk—that, due to the interconnectedness of the derivative markets, the bankruptcy of one derivatives market participant could cause a “ripple effect” or chain reaction of failures, threatening entire markets—caused Congress to provide special protections to certain derivative counterparties.

Congress determined that *ipso facto* termination provisions should be enforceable in bankruptcy cases for Safe Harbor Contracts. Moreover, Congress has enacted other provisions in the Bankruptcy Code which (i) exempt the non-debtor party to Safe Harbor Contracts from certain of the automatic stay provisions governing setoff and application of collateral, *see, e.g.*, 11 U.S.C. § 362(b)(6) (forward contracts); 11 U.S.C. § 362(b)(17) (swap agreements), and from any court-imposed stay of such setoff rights, *see* 11 U.S.C. § 362(o), and (ii) provide exceptions to certain avoidance provisions for transfers under Safe Harbor Contracts. *See generally* 11 U.S.C. § 546. These protections are collectively referred to as the “Safe Harbor Provisions.”

Although the Safe Harbor Provisions protect the exercise of *ipso facto* termination, liquidation and acceleration rights and setoff or application of collateral, they do not protect the exercise of all rights under a Safe Harbor Contract. *See In re Enron Corp.*, 306 B.R. 465, 473 (Bankr. S.D.N.Y. 2004); *In re Amcor Funding Corp.*, 117 B.R. 549, 551 (D. Ariz. 1990). For example, the Safe Harbor Provisions do not protect postpetition termination for breach of a representation unrelated to the debtor’s solvency, bankruptcy or financial condition. Also, the court in *Lehman Brothers* ruled that the Safe Harbor Provisions did not permit enforcement of an *ipso facto* subordination of a debtor’s right to payment under a swap transaction entered into in connection with a CDO. *See Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Limited (In re Lehman Brothers Holdings, Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

## b. Parties Protected by the Safe Harbor Provisions

In order to enjoy the protections of the Safe Harbor Provisions, a creditor must be within a category of Bankruptcy Code-specified protected parties, and exercising rights under a Safe Harbor Contract. The classes of protected counterparties under the Safe Harbor Provisions include:

- (i) a Forward Contract Merchant (11 U.S.C. § 101(26)) (an entity whose business consists in whole or part in entering into forward contracts as or with merchants in a commodity or similar good, article, service, right or interest which is or becomes the subject of dealing in the forward contract trade);
- (ii) a Swap Participant (11 U.S.C. § 101(53C)) (a counterparty to a prepetition swap agreement with the debtor);
- (iii) a Repo Participant (11 U.S.C. § 101(46)) (a counterparty to a prepetition repurchase agreement with the debtor);
- (iv) a Master Netting Agreement Participant (11 U.S.C. § 101(38B)) (a counterparty to a prepetition master netting agreement with the debtor);
- (v) a Stockbroker, Securities Clearing Agency, Financial Institution, Commodity Broker (11 U.S.C. § 101(53A), (48), (22), (6)); and
- (vi) a Financial Participant (11 U.S.C. § 101(22A)) (a party eligible under all safe harbors based on meeting minimum volume of trading requirements).

The classes of Safe Harbor Contracts include:

- (i) a Forward Contract (11 U.S.C. § 101(25)) (a contract for purchase or sale of a commodity with a maturity date more than 2 days after contract entered into);
- (ii) a Commodity Contract (U.S.C. § 761(4)) (exchange-traded commodity futures and options);

- (iii) a Swap Agreement (11 U.S.C. § 101(53)(B)) (includes commodity, interest rate, currency, debt, equity, total return swaps, also options, future or forward agreements);
- (iv) a Securities Contract (11 U.S.C. § 741(7)) (contract for purchase, sale or loan of a security);
- (v) a Repurchase Agreement (11 U.S.C. § 101(47)) (an agreement for transfer of certificates of deposit, mortgage loans or mortgage-related securities, or securities issued by or guaranteed by the United States, with simultaneous agreement to retransfer at a date certain within one year, or on demand); and
- (vi) a Master Netting Agreement (11 U.S.C. § 101(38)(A)) (a master agreement providing for the exercise of rights (such as termination and netting) under one or more of the foregoing types of protected contracts).

Where a contract contains both a safe harbored agreement and non-safe harbored agreements, the court may bifurcate the contract and extend safe harbor protection only to the eligible portion. *See Calyon N.Y. Branch v. Am. Home Mortg. Corp. (In re American Home Mortgage, Inc.)*, 379 B.R. 503 (Bankr. D. Del. 2008).

### c. Safe Harbor Provisions

The safe harbor protections available under the Bankruptcy Code fall into three major categories: (i) termination and related rights; (ii) automatic stay exceptions; and (iii) protection from avoidance.

The termination-related rights are found in the following Sections of the Bankruptcy Code:

- (i) Section 555 permits *ipso facto* termination, acceleration and liquidation of a securities contract by a stockbroker, financial institution, financial participant or securities clearing agency;
- (ii) Section 556 permits *ipso facto* termination, acceleration and liquidation of a commodity contract or forward contract by a commodity broker, financial participant or forward contract



merchant, and protects the right to a variation or maintenance margin payment received from the trustee under an open commodity contract or forward contract;

- (iii) Section 559 permits *ipso facto* termination, acceleration and liquidation of a repurchase agreement by a repo participant or financial participant;
- (iv) Section 560 permits *ipso facto* termination, acceleration and liquidation of a swap agreement by a swap participant or financial participant, as well as setoff or netting of termination values or payment amounts arising therefrom; and
- (v) Section 561 permits *ipso facto* termination, acceleration and liquidation and offset or netting under one or more Safe Harbor Contracts (*i.e.*, “cross product netting” under a master netting agreement).

The exceptions to the automatic stay are found in Sections 362(b) and (o) of the Bankruptcy Code. Sections 362(b)(6), (7), (17) and (27) provide relief from the automatic stay to exercise contractual rights to offset or net under Safe Harbor Contracts, or to exercise contractual rights under a security agreement or credit enhancement in connection with a Safe Harbor Contract. Moreover, under Section 362(o), a court may not enjoin the exercise of rights under Safe Harbor Contracts that are exempted from the automatic stay under Section 362(b).

Lastly, Section 546 of the Bankruptcy Code protects safe harbor counterparties from avoidance of certain prepetition transfers under or in connection with a Safe Harbor Contract. These provisions immunize the protected party from preference or “constructive” fraudulent conveyance claims. Transfers made with actual intent to hinder, delay or defraud are not protected.

In addition to the foregoing provisions, Sections 553 and 562 also touch upon safe harbor issues. As noted above in Chapter V.D.3., Section 553 generally preserves setoff rights in bankruptcy, provided the offsetting debt

and claim are both prepetition and are mutual,<sup>69</sup> but permits the court to avoid setoffs where (i) the claim was acquired within ninety days of the bankruptcy filing while the debtor was insolvent, (ii) the debt was acquired within ninety days of the filing, while the debtor was insolvent and for the purpose of obtaining a right of setoff, and (iii) the creditor's exercise of setoff within ninety days before filing "improved its position" (*i.e.*, reduced its net unsecured claim) during such ninety day period. Each of these three so-called "setoff avoidance" provisions contains an exception for the setoffs described in the Safe Harbor Provisions.

Regarding timing of damage claims, the general rule stated in Section 502 is that prepetition claims are valued as of the petition date. However, Section 562 contains a special rule—damages from the rejection or termination of a Safe Harbor Contract are determined as of the earlier of such rejection or termination (or, if no commercially reasonable determinants of value are available as of such time, the next date on which such determinants are available). Even though such claims may therefore be valued as of a date after the petition date, they are still deemed to be prepetition claims.

## 2. *Rejection of Collective Bargaining Agreements*

Congress adopted Section 1113 of the Bankruptcy Code as part of the 1984 Amendments to address issues arising in connection with the rejection of collective bargaining agreements. Today, a Chapter 11 debtor-in-possession or trustee (except in a railroad reorganization case) may assume or reject collective bargaining agreements only in accordance with the provisions of Section 1113. 11 U.S.C. § 1113(a).

Subsequent to the petition date and prior to filing an application to reject a collective bargaining agreement, the trustee must make a proposal to an authorized representative of the employees covered by such agreement that (i) provides for those modifications to the employee benefits and protections that are necessary to the debtor's reorganization and (ii) assures that all creditors, the debtor and all of the affected parties are treated fairly and equitably. 11 U.S.C. § 1113(b)(1)(A). The trustee is required to provide the employee representative with such relevant information as is necessary for the

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<sup>69</sup> The Safe Harbor Provisions, by their express terms, arguably override the mutuality requirement for setoffs. *Contra In re Lehman Brothers Holdings, Inc.*, No. 08-13555, 2010 Bankr. LEXIS 1260 (Bankr. S.D.N.Y. May 5, 2010).

representative to evaluate the proposal. 11 U.S.C. § 1113(b)(1)(B). In addition, during the period between submitting the proposal to the employee representative and filing an application to reject the collective bargaining agreement with the court, the trustee must meet with the employee representative at reasonable times to confer in good faith regarding mutually acceptable modifications to such agreement. 11 U.S.C. § 1113(b)(2).

The court shall only approve an application to reject a collective bargaining agreement if (i) the trustee has made a proposal that complies with the requirements described in the preceding paragraph, (ii) the employee representative has rejected such proposal without good cause, and (iii) the balance of the equities clearly favors rejection of such agreement. 11 U.S.C. § 1113(c).

The third prong described in the preceding paragraph codifies the standard for rejecting a collective bargaining agreement as articulated by the U.S. Supreme Court in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984). The “balance of the equities” standard is more stringent than the business judgment rule (discussed above at Chapter VI.C.2.), which is the standard courts apply to most decisions to assume or reject a contract. Generally, in determining whether a balancing of the equities exists in the context of Section 1113(c), a court will consider:

- (1) the likelihood and consequences of liquidation if rejection is not permitted;
- (2) the likely reduction in the value of creditors’ claims if the bargaining agreement remains in force;
- (3) the likelihood and consequences of a strike if the bargaining agreement is voided;
- (4) the possibility and likely effect of any employee claims for breach of contract if rejection is approved;
- (5) the cost-spreading abilities of the various parties, taking into account the number of employees covered by the bargaining agreement and how various employees’ wages and benefits compare to those of others in the industry; and
- (6) the good or bad faith of the parties in dealing with the debtor’s financial dilemma.

*Truck Drivers Local 807 v. Carey Transp. Inc.*, 816 F.2d 82, 93 (2d Cir. 1987) (citing *Bildisco*, 465 U.S. at 525-26).

Once the trustee has filed an application to reject a collective bargaining agreement, the court must hold a hearing on such application by no later than fourteen days after the date of filing of the application. 11 U.S.C. § 1113(d)(1). At least ten days' notice of the hearing must be provided to all interested parties, all of whom are entitled to appear and be heard at such hearing. *Id.* Where the circumstances of the case and the interests of justice require an extension for the commencement of the hearing on the rejection application, the court may extend the time by no more than seven days unless the trustee and employee representative agree to additional extensions. *Id.*

The court must rule on the rejection application within thirty days of the commencement of the hearing unless the court, in the interests of justice, extends the time for ruling by such additional time period as to which the trustee and the employee representative may agree. 11 U.S.C. § 1113(d)(2). In the event that the court fails to issue a ruling within such thirty-day period (or such other period as agreed to by the trustee and the employee representative), the trustee may terminate or alter any provisions of the collective bargaining agreement pending a ruling by the court. *Id.* The court is authorized to issue protective orders to the extent necessary to prevent disclosure of any information provided to the employee representative where such disclosure could compromise the debtor's position with respect to its competitors. 11 U.S.C. § 1113(d)(3).

During a period when the collective bargaining agreement remains in effect, after notice and a hearing, the court may authorize the trustee to implement interim modifications to the terms and conditions of such agreement if the modifications are essential to the continuation of the debtor's business or in order to avoid irreparable damage to the debtor's estate. 11 U.S.C. § 1113(e). Any hearing for such interim relief is to be scheduled in accordance with the trustee's needs, and the notice period for such hearing is often quite short. *See In re United Press Int'l, Inc.*, 134 B.R. 507, 513 (Bankr. S.D.N.Y. 1991) (finding that one day's notice of a hearing on interim modifications was sufficient). Additionally, there is no explicit requirement for the trustee to negotiate with, or provide information about the proposed interim modifications to, the employee representative prior to filing a motion for such relief. 11 U.S.C. § 1113(e).

The standard for approving interim relief is phrased in the alternative (“if essential to the continuation of the debtor’s business, or in order to avoid irreparable damage to the estate”), which suggests that a trustee need only satisfy one of them to prevail. See *United Press Int’l*, 134 B.R. at 514. At any rate, Congress likely intended that the standard for interim relief be markedly different than that for rejection. See, e.g., *United Food and Commercial Workers Union, Local 328 v. Almac’s, Inc.*, 90 F.3d 1, 6 (1st Cir. 1996) (comparing Section 1113’s comprehensive procedural and substantive safeguards for the rejection of collective bargaining agreements to the very “basic” safeguards required for interim relief under that same Section).

In no event shall any provision of Section 1113 be interpreted to permit a trustee to terminate or alter any provision of a collective bargaining agreement unilaterally without complying with the Section’s requirements. 11 U.S.C. § 1113(f). A trustee who does so violates both Section 1113(f) and the National Labor Relations Act (NLRA), which could subject the trustee to a charge of unfair labor practice. See *City & County of San Francisco v. PG&E Corp.*, 433 F.3d 1115 (9th Cir. 2006). Furthermore, in cases governed by the NLRA, a union may be free to strike “even following contract rejection under Section 1113. But a union’s right to strike under the NLRA depends upon the terms of the [collective bargaining agreement] to which it is a party (for instance, the existence or continued viability, or lack thereof, of a contractual “no-strike clause”).” *Northwest Airlines Corp. v. Ass’n of Flight Attendants*, 483 F.3d 160, 173 (2d Cir. 2007).<sup>70</sup>

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<sup>70</sup> The Railway Relations Act (RLA), however, which governs labor relations in the airline industry, continues to apply in bankruptcy. The Second Circuit has ruled that a strike following an airline debtor’s rejection of a collective bargaining agreement is barred by Section 2 (First) of the RLA, which requires “carriers and unions . . . [to] ‘exert every reasonable effort to make [agreements] . . . and to settle all disputes.’” *Northwest Airlines*, 483 F.3d at 173. Thus, “a union subject to the RLA would still be under an obligation first to ‘exert every reasonable effort to make [agreements] . . . and to settle all disputes’ . . . notwithstanding the non-viability of any contractual no-strike clause.” *Id.*

### 3. *Aircraft Equipment and Vessels*

Section 1110 of the Bankruptcy Code affords special protections to certain secured parties, lessors, and conditional vendors by allowing such parties, notwithstanding the commencement of a Chapter 11 case and the applicability of Sections 362, 363 and 1129 or any general injunctive power of a court, to exercise their nonbankruptcy rights and take possession of qualifying aircraft equipment or watercraft pursuant to an underlying security agreement, lease or conditional sales contract.<sup>71</sup> However, these protections only apply if the trustee<sup>72</sup> does not agree to perform under such agreement and to cure certain defaults.<sup>73</sup> 11 U.S.C. § 1110(a).

To qualify for protection under Section 1110, the aircraft equipment must be:

an aircraft, aircraft engine, propeller, appliance, or spare part (as defined in section 40102 of title 49) that is subject to a security interest granted by, leased to, or conditionally sold to a debtor that, at the time such transaction is entered into, holds an air carrier operating certificate issued by the Secretary of Transportation pursuant to chapter 447 of title 49 for aircraft capable of carrying 10 or more individuals or 6,000 pounds or more of cargo.

11 U.S.C. § 1110(a)(3)(A)(i). Similarly, qualifying watercraft must be:

a vessel documented under chapter 121 of title 46 that is subject to a security interest granted by, leased to, or conditionally sold to a debtor that is a water carrier that, at

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<sup>71</sup> For purposes of Section 1110, with respect to equipment that was first placed into service on or before October 22, 1994, (a) the term “lease” is limited to any written agreement in which the lessor and the debtor, as lessee, have expressed in the agreement or in a substantially contemporaneous writing that such agreement is to be treated as a lease for Federal income tax purposes and (b) the term “security interest” is limited to a purchase-money equipment security interest.

<sup>72</sup> As described in more detail in Chapter VI.A. below, references to a trustee in the Bankruptcy Code are interpreted to include a debtor-in-possession.

<sup>73</sup> The only defaults that are not subject to this cure requirement are defaults under *ipso facto* or bankruptcy clauses (discussed above at Chapter V.E.3.e.).

the time such transaction is entered into, holds a certificate of public convenience and necessity or permit issued by the Department of Transportation.

*Id.*; 11 U.S.C. § 1110(a)(3)(A)(ii). In both cases, “all records and documents [(e.g., log books and service records)] relating to such equipment that are required, under the terms of the security agreement, lease, or conditional sale contract, to be surrendered or returned by the debtor in connection with the surrender or return of such equipment” must also be turned over to the creditor. 11 U.S.C. § 1110(a)(3)(B).

The option of the trustee to perform and cure (sometimes referred to as the “Section 1110(a) election”) is subject to certain limitations, however. First, the trustee only has sixty days from the date of the order for relief under Chapter 11 (the “Sixty-Day Period”) in which to make the Section 1110(a) election unless the contracting parties agree, subject to approval of the court, to an extension of the Sixty-Day Period. 11 U.S.C. § 1110(a)(2)(A)–(B). *See In re Pan Am Corp.*, 124 B.R. 960, 974 (Bankr. S.D.N.Y. 1991). During the Sixty-Day Period (and any agreed-upon extensions thereof), the automatic stay remains in effect with respect to the aircraft equipment or watercraft unless otherwise ordered by the court. Additionally, the trustee’s agreement to perform is subject to the court’s approval. This decision by the trustee is protected by the business judgment rule (discussed below at Chapter VI.C.2).

Second, the trustee must cure any defaults within specified timeframes: (i) any prepetition defaults must be cured within the Sixty-Day Period; (ii) any defaults occurring after entry of the order for relief and before the expiration of the Sixty-Day Period must be cured before the later of the date that is thirty days after the date of the default or the expiration of the Sixty-Day Period; and (iii) any defaults occurring on or after the expiration of the Sixty-Day Period must be cured in accordance with the underlying agreement, if a cure is permitted thereunder. 11 U.S.C. § 1110(a)(2).

In the event that the trustee fails to make an 1110 election with respect to particular aircraft equipment or watercraft as described above, the trustee must immediately surrender and return such aircraft equipment or watercraft upon a written demand by the applicable secured party, lessor or conditional vendor. 11 U.S.C. § 1110(c)(1). Notably, the underlying agreement need not reference Section 1110 in order for the provisions of such Section to apply thereto. *See H. REP. NO. 595*, 95th Cong., 1st Sess. 240 (1977).

Additionally, the fact that the trustee lacks actual possession of the aircraft equipment or watercraft is irrelevant to the right of the applicable secured party, lessor or conditional vendor to take possession of such aircraft equipment or watercraft.

Finally, it is worth noting that Section 1110 does not indicate whether the trustee must comply with all of the conditions for return of the collateral set forth in the underlying agreement. It is unclear whether “the statute could be read in such a way that the estate would be required to shoulder, as an administrative expense, the costs of actually returning the [collateral] (which might, for example, include the cost of reinstalling original engines where those engines had been removed for repair or overhaul) to the lenders or lessors, or to pay, as an administrative expense, the lenders’ or lessors’ costs of retrieving their [collateral] and making [it] airworthy [or seaworthy].” *In re US Airways Group, Inc.*, 287 B.R. 643, 646 (Bankr. E.D. Va. 2002).



# VI

REORGANIZATION (CHAPTER 11)



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## VI. Reorganization (Chapter 11)

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### A. Debtor-in-Possession

As discussed in Chapter I.A. above, a debtor becomes a “debtor-in-possession” upon filing a voluntary petition under Chapter 11 or, in an involuntary Chapter 11 case, upon entry of the order for relief, and will continue as a “debtor-in-possession” for the duration of the Chapter 11 case unless and until a trustee is appointed. 11 U.S.C. § 1101(1). A debtor-in-possession generally enjoys the rights and powers of a Chapter 11 trustee and is required to perform the duties and obligations of a Chapter 11 trustee (except for investigative duties). 11 U.S.C. § 1107(a). In the case of a Chapter 11 debtor that is a corporation or other business, existing management will generally remain in place (subject to certain exceptions discussed in the following Section).

It is also worth noting that the debtor-in-possession is the only party with the right to file a plan within the first 120 days of a bankruptcy case (with certain exceptions). This exclusivity period can be increased or reduced by the court for cause, on request of a party in interest, and after notice and a hearing. 11 U.S.C. § 1121.<sup>74</sup>

### B. Chapter 11 Trustee and Examiner

At the request of a party in interest or the U.S. Trustee, and after notice and a hearing, the court must order the appointment of a Chapter 11 trustee (replacing the debtor-in-possession) to operate the business and manage the estate and reorganization effort (i) upon a showing of cause, including fraud, dishonesty, incompetence or gross mismanagement by current management (either before or after the bankruptcy filing), (ii) if such appointment is in the interests of creditors, equity security holders and other interests of the estate, or (iii) if grounds exist to dismiss or convert the case but appointment of a trustee (or examiner) is in the best interests of creditors and the estate. 11 U.S.C. §§ 1104(a), 1108. Generally, the standards for appointment of a Chapter 11 trustee are quite high. The protection provided by a trustee must be necessary, and the costs and expenses must not be disproportionately higher than the value of the protection afforded by the trustee. There is a

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<sup>74</sup> See discussion of “Exclusivity” in Chapter VI.F.1. below.

strong presumption against the appointment of an outside trustee, and the moving party must prove the need for such appointment by clear and convincing evidence. See *In re G-I Holdings, Inc.*, 385 F.3d 313 (3d Cir. 2004).

The duties of a Chapter 11 trustee include:

- (i) performing certain duties of a Chapter 7 trustee (including being accountable for all property received, examining proofs of claim and filing objections thereto as appropriate, furnishing information about the estate and the administration thereof filing periodic reports and summaries of the operation of the debtor's business with the relevant taxing authorities and making a final report and filing a final account of the administration of the estate);
- (ii) filing the list of creditors, schedules of assets and liabilities and the statement of the debtor's financial affairs (to the extent that the debtor has not already done so);
- (iii) except to the extent that the court orders otherwise, investigating the acts, conduct, assets, liabilities and financial condition of the debtor, the operation of the debtor's business and the desirability of continuing such business, and any other matter relevant to the case or to the formulation of a plan;
- (iv) filing a statement of any investigation conducted pursuant to the preceding subparagraph;
- (v) filing a plan or a report as to why the trustee will not file such a plan or recommending conversion or dismissal of the bankruptcy case;
- (vi) furnishing information for any year for which the debtor has not filed a tax return to the taxing authority with whom such return was to be filed; and
- (vii) filing any necessary post-confirmation reports.

11 U.S.C. § 1106(a).

If the court does not appoint a Chapter 11 trustee, on request of a party in interest or the U.S. Trustee, and after notice and a hearing, the court is required to appoint an examiner to conduct an investigation of the debtor, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct or irregularity in the management of the debtor's affairs by current or former management, if (i) such appointment is in the best interests of creditors, equity security holders and other interests of the estate or (ii) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services or taxes, or owing to an insider, exceed \$5,000,000. 11 U.S.C. § 1104(c). Although appointment of an examiner is mandatory upon a showing of cause, "the bankruptcy court retains broad discretion to direct the examiner's investigation, including its nature, extent, and duration." *In re Revco D.S., Inc.*, 898 F.2d 498, 501 (6th Cir. 1990).

Following entry of an order for the appointment of either a Chapter 11 trustee or an examiner, the U.S. Trustee appoints a disinterested person to such position. If a party in interest makes a request for an election of the Chapter 11 trustee within thirty days of the court's order for the appointment of a trustee, however, the U.S. Trustee must convene a meeting of creditors for the purpose of electing a Chapter 11 trustee. Such election of a Chapter 11 trustee is conducted in the same manner as an election for a Chapter 7 trustee (discussed below in Chapter VII.B.1.).

## C. Operation of the Business

### 1. *Authorization to Operate the Business*

The Bankruptcy Code authorizes the debtor-in-possession or the trustee to operate the debtor's business as a matter of course and without further court order, although the bankruptcy court may terminate such authority on request of a party in interest and upon notice and a hearing. 11 U.S.C. § 1108. See *Goss v. Morgansen's Ltd.*, No. 04-CV-0268, 2005 U.S. Dist. LEXIS 43600, at \*13-14 (E.D.N.Y. Sept. 27, 2005). In operating the business, the debtor-in-possession or trustee "has a duty to exercise that measure of care and diligence that an ordinary prudent person would exercise under similar circumstances . . . to conserve the assets of the estate and to maximize distribution[s] to creditors." *In re Rigden*, 795 F.2d 727, 730 (9th Cir. 1986). Additionally, the debtor-in-possession or trustee is also bound by

a duty of loyalty, which requires it to refrain from self-dealing, avoid conflicts of interest and the appearance of impropriety and treat all parties to the case fairly. See *In re Coram Healthcare Corp.*, 271 B.R. 228, 235 (Bankr. D. Del. 2001).

## 2. *Ordinary Course of Business and the Business Judgment Rule*

When reviewing an action taken by a trustee or debtor-in-possession in a bankruptcy proceeding, there are two relevant inquiries—first, whether the action is in or out of the ordinary course of the debtor’s business and second, whether the action is within the trustee’s reasonable exercise of its business judgment. Whereas the former question generally applies only to transactions where the trustee seeks to use, sell or lease property of the estate, the latter applies not only to those transactions, but also to many other actions in a bankruptcy proceeding, including, for example, decisions regarding assumption or rejection of executory contracts and unexpired leases.

Although nothing in the Bankruptcy Code provides a framework for determining if a transaction is in “the ordinary course of business,” most courts undertake a two-part inquiry to answer this question. The first step (commonly referred to as the “horizontal dimension” test) considers “whether, from an industry-wide perspective, the transaction is of the sort commonly undertaken by companies in [the applicable] industry.” *In re Roth Amer., Inc.*, 975 F.2d 949, 963 (3d Cir. 1992). The second step (known as the “vertical dimension” test) “analyzes the transactions ‘from the vantage point of a hypothetical creditor and [inquires] whether the transaction subjects a creditor to economic risk of a nature different from those he accepted when he decided to extend credit.’” *Id.* (internal citation omitted). Both tests must be satisfied for a court to deem a transaction to be in “the ordinary course of business.”

Generally, the decisions of a debtor-in-possession or trustee made in the ordinary course of operating a debtor’s business are protected by the business judgment rule. See *In re Integrated Resources, Inc.*, 147 B.R. 650, 656 (Bankr. S.D.N.Y. 1992) (once a debtor-in-possession has articulated a valid business justification for a decision, a presumption arises that such decision was made “on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company.”). Courts are normally reluctant to second-guess the ordinary course business decisions of a debtor-

in-possession or trustee except upon a showing that the trustee acted in bad faith. See, e.g., *In re Nellson Nutraceutical, Inc.*, 369 B.R. 787, 797 (Bankr. D. Del. 2007) (stating that a “Court will not entertain an objection to [a] transaction, provided that the conduct involves a business judgment made in good faith upon a reasonable basis and within the scope of authority under the Bankruptcy Code.”).

### 3. *Suits Against Fiduciaries for Actions Taken While Operating the Business*

Notwithstanding the foregoing favorable doctrines, however, operation of a debtor’s business by a trustee or debtor-in-possession is not free from risk. Just as is the case outside of bankruptcy, “[t]rustees, receivers or managers of any property, including debtors in possession, may be sued, without leave of the court appointing them, with respect to any of their acts or transactions in carrying on business connected with such property.” 28 U.S.C. § 959(a). Such actions shall be subject to the general equity power of the court appointing them so far as may be necessary to serve the ends of justice. *Id.* Additionally, Chapter 11 trustees (and debtors-in-possession) are required to manage and operate the property in their possession in compliance with applicable State law. 28 U.S.C. § 959(b).

Estate fiduciaries are, however, protected by what is known as the “Barton Doctrine” against liability for acts taken in furtherance of the administration of the case (as opposed to the operation of the debtor’s business). *Vass v. Conron Bros. Co.*, 59 F.2d 969 (2d Cir. 1932). Since *Vass*, a long line of cases has held that, as a matter of Federal common law, individuals who wish to sue a trustee must “first obtain leave of the court that appointed the trustee.” See *Peia v. Coan*, No. 3:05cv1029, 2006 U.S. Dist. LEXIS 12811, at \*2-3 (D. Conn. March 23, 2006). This doctrine also has been applied in other contexts to protect an auctioneer of a debtor’s property as well as a U.S. Marshal and the U.S. Trustee. See *Carter v. Rogers*, 220 F.3d 1249, 1252 (11th Cir. 2000); *In re Stone*, No. 92-01383, 1998 Bankr. LEXIS 1976 (Bankr. D. D.C. Nov. 4, 1998).

## D. Creditors' Committee

Shortly after entry of the order for relief under Chapter 11, the U.S. Trustee shall appoint a committee of unsecured creditors. 11 U.S.C. § 1102(a)(1). The only exception to this mandate is in a small business case, where the court may order that a committee of unsecured creditors not be appointed. 11 U.S.C. § 1102(a)(3).<sup>75</sup> The U.S. Trustee also has the discretion to appoint additional committees of creditors or equity security holders as it deems appropriate. 11 U.S.C. § 1102(a)(1). In addition, on request of a party in interest, the court may order the appointment of additional committees of creditors or equity security holders to ensure adequate representation. 11 U.S.C. § 1102(a)(2).

Once a committee has been appointed, the trustee or debtor-in-possession is required to meet with such committee to transact such business as may be necessary and proper. 11 U.S.C. § 1103(d). Committees appointed by the U.S. Trustee represent the class of creditors or equity holders from which they are selected and act as the primary negotiating bodies for the formulation of a plan. See *In re SPM Mfg. Corp.*, 984 F.2d 1305, 1316 (1st Cir. 1993) (“The committee as the sum of its members is not intended to be merely an arbiter but a partisan which will aid, assist, and monitor the debtor pursuant to its own self-interest.”) (internal citation omitted).

A committee of unsecured creditors typically consists of the persons willing to serve that hold the seven largest unsecured claims against the debtor. In certain cases, a creditors' committee can be comprised of the members of a committee that was organized prior to commencement of the bankruptcy case, provided that such committee was fairly chosen and is representative of the different kinds of claims to be represented.<sup>76</sup> 11 U.S.C. § 1102(b)(1).

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<sup>75</sup> A small business debtor is defined as “a person engaged in commercial or business activities . . . that has aggregate non-contingent liquidated secured and unsecured debts . . . in an amount not more than \$2,343,000 . . .” 11 U.S.C. § 101(51D).

<sup>76</sup> Bankruptcy Rule 2007(b) sets forth certain criteria for determining if such a pre-bankruptcy committee was fairly chosen, including whether (i) it was selected by a majority of unsecured creditors holding allowable, undisputed, fixed, liquidated claims at a meeting of which (a) all creditors holding unsecured claims over \$1000 had at least seven days notice in writing and (b) written minutes reporting the names of creditors present or represented and voting, and the amounts of their claims, were kept and are available for inspection, (ii) all proxies voted at such meeting were properly solicited and all required



On request of a party in interest and after notice and a hearing, the court may order the U.S. Trustee to change the committee's membership if the court determines that a change is necessary to ensure adequate representation. The court may also order the U.S. Trustee to increase the number of members of a committee to include a creditor that is a small business concern<sup>77</sup> if such creditor holds claims (of the kind represented by the committee) the aggregate amount of which, in comparison to the annual gross revenue of that creditor, is disproportionately large. 11 U.S.C. § 1102(a)(4).

Similar to a trustee, a creditors' committee performs duties in the administration of the bankrupt estate, including:

- (i) consulting with the trustee or debtor-in-possession concerning the administration of the case;
- (ii) investigating the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
- (iii) participating in the formulation of a plan, advising the creditors represented by such committee of such committee's determinations as to any plan formulated, and collecting and filing with the court acceptances or rejections of a plan;
- (iv) requesting the appointment of a trustee or examiner under Section 1104 of the Bankruptcy Code; and
- (v) performing such other services as are in the interest of the creditors represented by such committee.

11 U.S.C. § 1103(c). The committee also has a duty to provide the class of creditors which it represents with access to information and to solicit and receive comments from those creditors. 11 U.S.C. § 1102(b)(3).

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data collected with respect to such proxies has been submitted to the U.S. Trustee, and (iii) the organization of the committee was in all other respects fair and proper.

<sup>77</sup> The Small Business Act defines a small business concern as "one which is independently owned and operated and which is not dominant in its field of operation." Small Business Act, PUB. L. NO. 85-536 § (3)(a)(1).

Additionally, a creditors' committee, like a trustee, is held to certain fiduciary standards. See *In re Smart World Techs., LLC*, 423 F.3d 166, 175 n.12 (2d Cir. 2005) (“A creditors' committee owes a fiduciary duty to the class it represents, but not to the debtor, other classes of creditors, or the estate.”).

## E. Plan Solicitation and Disclosure Statement

As will be discussed in more detail below, certain of the requirements for confirmation (or approval) of a Chapter 11 plan focus on whether or not the different classes of creditors and equity interest holders support the plan. Before a creditor or equity interest holder is entitled to vote on a plan, however, the plan proponent must solicit their votes by providing them with certain court approved materials.

### 1. Plan Solicitation and Disclosure Statement

Acceptance or rejection of a plan may not be solicited postpetition from the holder of a claim or interest unless prior to the solicitation such holder has received the plan (or a summary thereof) and a written disclosure statement that has been approved by the court as containing “adequate information.” 11 U.S.C. § 1125(b). The only exception is that, in a small business case, the court may determine that the plan itself contains adequate information and that a separate disclosure statement is not required. 11 U.S.C. § 1125(f).

The Bankruptcy Code defines adequate information as “information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor’s books and records . . . [so as to enable a hypothetical investor] of the relevant class to make an informed judgment about the plan . . . .” 11 U.S.C. § 1125(a)(1).

There are a number of categories of information that are typically included in a disclosure statement, including the circumstances giving rise to the bankruptcy filing, a description of the available assets and their value, a summary of the debtor’s anticipated future performance together with accompanying financial projections, information regarding claims against the estate, an analysis of the debtor’s enterprise value and a liquidation analysis setting forth the estimated return to creditors in a hypothetical Chapter 7 case. See *In re Oxford Homes, Inc.*, 204 B.R. 264, 269 n.17 (Bankr. D. Me. 1997).

Although the same disclosure statement must be transmitted to each holder of a claim or interest in a particular class, different disclosure statements may be transmitted to the different classes of claims or interests. 11 U.S.C. § 1125(c). Bankruptcy Rules 3016, 3017 and 3017.1 set forth the procedures for the filing and court consideration of the plan and disclosure statement.

In certain circumstances, prepetition acceptance or rejection of a plan may be effective. 11 U.S.C. § 1125(g). A holder of a claim or interest that has accepted or rejected a plan prepetition is deemed to have accepted or rejected such plan provided that (i) the prepetition solicitation complied with any applicable nonbankruptcy law governing the adequacy of disclosure in connection with such solicitation or (ii) in the absence of such law, the holder's acceptance or rejection was solicited after disclosure of adequate information as defined in the Bankruptcy Code. 11 U.S.C. § 1126(b). In this situation, the solicitation of votes takes place first and then the bankruptcy court reviews the disclosure provided and solicitation process undertaken and determines in hindsight if it satisfies Section 1126(b) of the Bankruptcy Code. This process helps to effectuate what is commonly referred to as a "pre-packaged" bankruptcy.

## 2. *Voting Rules*

In determining which creditors and equity interest holders are entitled to vote on a plan, there are two issues that must be addressed: (i) whether a particular creditor or equity interest holder is entitled to vote on a Chapter 11 plan and (ii) whether a particular class of creditors or equity interest holders is entitled to vote on a Chapter 11 plan.

A holder of a claim or interest is eligible to vote to accept or reject the plan if such holder's claim or interest has been "allowed." 11 U.S.C. § 1126(a). If a party in interest has filed an objection to a claim or interest, regardless of the merits or validity of such objection, the claimant or interest holder will not be allowed to vote on the plan unless the court temporarily allows the claim or interest for voting purposes (or fully adjudicates the objection and allows the claim prior to the voting deadline). Fed. R. Bankr. P. 3018(a).

Whether a particular class is entitled to vote on a plan depends on the treatment provided to that class under the plan. In short, only those classes which are impaired but receiving property under the plan are entitled to vote on the plan. Unimpaired classes are conclusively presumed to have accepted the plan, making solicitation from the holders of claims or interests in such classes unnecessary. 11 U.S.C. § 1126(f).<sup>78</sup> Conversely, a class is deemed to have rejected a plan (again rendering solicitation unnecessary) if the plan provides that the holders of the claims or interests in such class will not receive or retain any property under the plan on account of such claims or interests. 11 U.S.C. § 1126(g).

A class of claims entitled to vote on a plan is deemed to accept a plan if creditors holding at least two-thirds in amount and more than one-half in number of the allowed claims in such class that voted on the plan have voted to accept the plan. 11 U.S.C. § 1126(c). A class of interests entitled to vote on a plan is deemed to accept a plan if holders of at least two-thirds in amount of the allowed interests in such class that voted on the plan have voted to accept the plan. 11 U.S.C. § 1126(d). In determining whether a class accepts or rejects the plan, a court, upon request of a party in interest and after notice and a hearing, may disqualify any acceptance or rejection that was not made in good faith or that was not solicited in good faith or in accordance with the provisions of the Bankruptcy Code. 11 U.S.C. § 1126(e). If a vote is so designated, it is excluded from the calculations made pursuant to Sections 1126(c) and (d) of the Bankruptcy Code.

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<sup>78</sup> See Chapter VI.F.3. for a discussion of unimpairment.

## F. Chapter 11 Plan

Unlike Chapter 7, where the distributions to creditors and equity holders are governed strictly by the Bankruptcy Code, distributions in Chapter 11 cases are, to a very large extent, far more flexible. Although there are rules governing distributions to creditors and equity holders in Chapter 11, parties are given wide latitude in crafting the plan and providing for distributions under the plan. Set forth below is a summary of the more important rules governing the plan process in Chapter 11.

### 1. *Exclusivity*

The debtor-in-possession enjoys the exclusive right to file a plan for the first 120 days of a Chapter 11 bankruptcy case. 11 U.S.C. § 1121(b). In a small business case, the debtor-in-possession's exclusive period is increased to 180 days. 11 U.S.C. § 1121(e). The debtor's exclusive period ends (i) upon the appointment of a Chapter 11 trustee, (ii) if the debtor has not filed a plan prior to the expiration of the 120-day period or (iii) if the debtor has not filed a plan that has been accepted by each impaired class of claims or interests within the first 180 days of the bankruptcy case. 11 U.S.C. § 1121(c). Both the 120-day and 180-day periods referenced in clauses (ii) and (iii), respectively, can be reduced or increased for cause by the court. 11 U.S.C. § 1121(d)(1). However, the 120-day period cannot be extended beyond a date that is eighteen months after the date of the order for relief, and the 180-day period cannot be extended beyond a date that is twenty months after the date of the order for relief. 11 U.S.C. § 1121(d)(2). Once the debtor's exclusive period ends, any party in interest may propose a plan, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder or an indenture trustee. 11 U.S.C. § 1121(c).

## 2. *Classification of Claims and Interests*

When formulating a Chapter 11 plan, the plan proponent is required to divide the various holders of claims and equity interests into different groupings or “classes.” These classes are generally organized by type of claim or interest. In particular, a plan may only classify a claim or an interest in a particular class if such claim or interest is substantially similar to the other claims or interests comprising such class. 11 U.S.C. § 1122(a). A plan, however, may designate a separate class of claims consisting only of those unsecured claims that are less than or reduced to an amount approved by the bankruptcy court as reasonable and necessary for administrative convenience. 11 U.S.C. § 1122(b). Such a class is commonly referred to as a “convenience class.”

Additionally, although the Bankruptcy Code does not expressly prohibit the separate classification of similar claims, a debtor may not separately classify claims solely to obtain the vote of an impaired, assenting class. Instead, the debtor has the discretion to classify claims separately only where there are “significant disparities” between the legal rights of the holders of different claims or if there are “good business reasons” for doing so. *In re Wabash Valley Power Ass’n*, 72 F.3d 1305 (7th Cir. 1995).

## 3. *Treatment of Claims and Interests*

Under a plan, each holder of a claim or interest is entitled to a particular treatment on account of such claim or interest. There are two general types of treatment under the Bankruptcy Code—“unimpaired” treatment and “impaired” treatment. As noted above, whether a class of claims or interests is impaired determines whether such class is entitled to vote on the plan. As discussed in greater detail below, a plan can only be confirmed if at least one class of impaired claims votes to accept the plan, and a class of claims or interests that is unimpaired is conclusively deemed to have accepted the plan.

A claim or interest is unimpaired if the plan (i) leaves unaltered the legal, equitable or contractual rights of the holder of such claim or interest or (ii) reinstates such claim or interest. 11 U.S.C. § 1124; see *In re Wabash Valley Power Ass’n*, 72 F.3d at 1321 (“The standard for impairment is very lenient and ‘any alteration of the rights constitutes impairment even if the value of the rights is enhanced.’”) (internal citation omitted). To reinstate a claim or interest, a debtor must (i) cure any defaults in the underlying obligation, (ii)

reinstate the original maturity of the obligation as such maturity existed prior to the default, (iii) compensate the holder of such claim or interest for any damages incurred as a result of reliance by such holder on contractual provisions or applicable law, (iv) compensate the holder of such claim or interest for any actual pecuniary loss suffered as a result of the debtor's failure to perform any nonmonetary obligations other than a failure to operate a nonresidential real property lease subject to Section 365(b)(1)(A), and (v) not otherwise alter the legal, equitable or contractual rights of the holder of such claim or interest. 11 U.S.C. § 1124(2).

#### 4. *Mandatory Plan Provisions*

Every Chapter 11 plan is required to:

- (i) designate classes of claims and interests;
- (ii) specify any unimpaired class of claims or interests;
- (iii) specify the treatment of any impaired class of claims or interests;
- (iv) provide the same treatment for each claim or interest of a particular class, unless the holder of the particular claim or interest agrees to less favorable treatment;
- (v) provide adequate means for the plan's implementation such as the:
  - (a) retention by the debtor of all or any part of the property of the estate,
  - (b) transfer of all or any part of the property of the estate to one or more entities,
  - (c) merger or consolidation of the debtor with one or more persons,
  - (d) sale of all or any part of the property of the estate or distribution of all or any part of the property of the estate among those having an interest in such property,

- (e) satisfaction or modification of any lien,
  - (f) cancellation or modification of any indenture or similar instrument,
  - (g) cure or waiver of any default,
  - (h) extension of a maturity date or a change in an interest rate or other term of outstanding securities,
  - (i) amendment of the debtor's charter, or
  - (j) issuance of securities of the debtor for cash, property or existing securities or in exchange for claims, interests or any other appropriate purpose;
- (vi) provide that any corporate debtor's charter prohibits the issuance of nonvoting equity securities and provides for the appropriate distribution of voting power among the various classes of equity securities;
- (vii) contain only provisions that are consistent with the interests of creditors and equity security holders, and with public policy with respect to the manner of selection of any officer, director or trustee under the plan; and
- (viii) in the case of an individual debtor, provide for the payment to creditors of all or such portion of earnings from personal services performed by the debtor postpetition, or other future income as is necessary for execution of the plan.

11 U.S.C. § 1123(a).



## 5. *Permissive Plan Provisions*

In addition to the mandatory provisions described above, a Chapter 11 plan may also:

- (i) impair or leave unimpaired any class of claims or interests;
- (ii) provide for the assumption, rejection or assignment of any executory contract or unexpired lease of the debtor not previously rejected;
- (iii) provide for:
  - (a) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate; or
  - (b) the retention and enforcement by the debtor, the trustee or a representative of the estate appointed for such purpose, of any such claim or interest;
- (iv) provide for the sale of all or substantially all of the property of the estate and the distribution of the proceeds thereof among holders of claims or interests;
- (v) modify the rights of holders of secured claims (other than a mortgage secured by the debtor's principal residence) or unsecured claims or leave unaffected the rights of holders of any class of claims; and
- (vi) include any other appropriate provision not inconsistent with the Bankruptcy Code.

11 U.S.C. § 1123(b).

## 6. Chapter 11 Liquidating Plans

In some cases, a Chapter 11 plan may provide for the liquidation of a debtor's business. Proponents of a Chapter 11 liquidating plan must still satisfy the requirements of Section 1123 of the Bankruptcy Code described above, as well as the confirmation requirements discussed below in Chapter VI.G. Among the requirements for confirmation of a plan is that administrative priority claims and certain other priority claims be paid in full. 11 U.S.C. § 1129(a)(9). Thus, the plan proponent must ensure that sufficient funds will be available to satisfy certain claims, including all administrative expense claims and certain unsecured priority claims (discussed in greater detail below). Otherwise, the case will be deemed "administratively insolvent" and will likely be converted to Chapter 7. Businesses often prefer to liquidate their assets under Chapter 11 (as opposed to Chapter 7) because it allows the existing management to remain in place, which arguably allows a more orderly liquidation to take place, thus increasing the ultimate return to creditors.

## 7. Modification of a Plan

Proponents of a plan will sometimes be faced with unanticipated circumstances subsequent to the solicitation of votes on, or even confirmation of, such plan. In certain situations, this may require modification of the plan. Section 1127 of the Bankruptcy Code provides certain requirements plan proponents must meet if they wish to modify the terms of a plan. First, the Bankruptcy Code provides that a plan proponent may modify a plan at any time before or after confirmation of the plan but prior to "substantial consummation"<sup>79</sup> of the plan as long as the modified plan meets the requirements of Sections 1122 and 1123 of the Bankruptcy Code (discussed in Chapter VI.F.2. and VI.F.4–5., respectively). 11 U.S.C. § 1127(a)–(b). Additionally, the modified plan must comport with all the requirements of Sections 1121 through 1129. 11 U.S.C. § 1127(f).

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<sup>79</sup> This term is defined in Section 1101(2) of the Bankruptcy Code as a "(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."

Moreover, in modifying a plan, a plan proponent must comply with Section 1125 of the Bankruptcy Code, which governs postpetition disclosure and solicitation. 11 U.S.C. § 1127(c). Section 1127(d) also provides that holders of claims or interests that have previously accepted or rejected the plan will be deemed to accept or reject the modified plan according to their previous votes, unless such holder changes its acceptance or rejection within the time fixed by the court.

If the debtor is an individual, upon the request of the debtor, trustee, U.S. Trustee, or an unsecured creditor, a plan may be modified at any time after confirmation but prior to the completion of payments under the plan whether or not the plan has been “substantially consummated.” 11 U.S.C. § 1127(e). The requesting party may seek to increase or reduce the amount of payments on claims of a particular class, modify the time period for such payments, or modify the amount of the distribution to a creditor to the extent such creditor has been paid other than under the plan. *Id.*

## G. Plan Confirmation

The court must confirm a plan before the plan will become effective and binding on all parties. To confirm a plan, the court will schedule a confirmation hearing to determine whether the plan complies with the provisions of Section 1129 of the Bankruptcy Code. 11 U.S.C. § 1128(a). Bankruptcy Rule 2002 governs the notice requirements for a confirmation hearing.

When the court finds that the plan satisfies all confirmation requirements, it will enter an order of confirmation that conforms to the requirements of Bankruptcy Rule 3020(c). However, such an order may be revoked on request of a party in interest, after notice and a hearing, at any time before 180 days after the date the confirmation order was entered. 11 U.S.C. § 1144. The court may only revoke the confirmation order if it finds that the order was procured by fraud. *Id.*

## 1. *Consensual Confirmation*

In order for a court to confirm a plan, the following requirements must be satisfied:

- (i) the plan and the proponent of such plan must comply with the applicable provisions of the Bankruptcy Code;
- (ii) the plan must be proposed in good faith and not by any illegal means;
- (iii) any payment made or to be made by the plan proponent, the debtor, or any person issuing securities or acquiring property under the plan, for services or for costs and expenses in or in connection with the case, or in connection with the plan and incident to the case, must be approved by, or be subject to the approval of, the court as reasonable;
- (iv) the plan proponent must disclose the identity and affiliations of any individual proposed to serve post-confirmation as a director, officer or voting trustee of the debtor, an affiliate of the debtor participating in a joint plan with the debtor, or a successor to the debtor under the plan, and such appointment must be consistent with the interests of creditors and equity security holders and with public policy;
- (v) the plan proponent must disclose the identity of any insider that will be employed or retained by the reorganized debtor and the nature of any compensation for such insider;
- (vi) any governmental regulatory commission with post-confirmation jurisdiction over the debtor's rates must approve any rate change (or such rate change must be expressly conditioned on such approval);
- (vii) with respect to each impaired class of claims or interests, (i) each holder of a claim or interest of such class must (A) accept the plan or (B) receive or retain under the plan on account of such claim or interest property of a value, as of the plan's effective date, that

is not less than the amount such holder would receive in a hypothetical Chapter 7 liquidation of the debtor (the so-called “best interests” test) or (ii) if such class has made the Section 1111(b) election (discussed above in Chapter V.D.2.b.) each holder of a claim in such class must receive or retain under the plan on account of such claim property of a value, as of the plan’s effective date, that is not less than the value of such holder’s interest in the estate’s interest in the property securing such claims;

- (viii) each class of claims or interests must accept the plan or be unimpaired;
- (ix) except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan must provide that (i) on the plan’s effective date, each holder of administrative expense claims and certain unsecured priority claims<sup>80</sup> will receive a cash payment equal to the allowed amount of such claims, (ii) with respect to classes of certain unsecured priority claims,<sup>81</sup> each holder of such claim will receive (a) if such class has accepted the plan, deferred cash payments of a value, as of the plan’s effective date, equal to the allowed amount of such claim or (b) if such class has not accepted the plan, cash on the plan’s effective date equal to the allowed amount of such claim, and (iii) with respect to unsecured tax claims, each holder of a such a claim will receive on account of such claim regular installment payments in cash (a) of a total value, as of the plan’s effective date, equal to the allowed amount of such claim, (b) over a period ending not later than five years after the date of the order for relief, and (c) in a manner not less favorable than the most favored nonpriority unsecured claim provided for by the plan;

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<sup>80</sup> These claims include priority claims in an involuntary case that, although they arose in the ordinary course of the debtor’s business after the bankruptcy filing, are treated as if they arose prepetition (these are sometimes called “gap period” claims).

<sup>81</sup> These claims include priority claims for domestic support obligation claims, wage claims, employee benefit claims, claims of grain producers and fishermen and consumer claims.

- (x) at least one class of impaired claims must accept the plan, excluding any acceptance of the plan by any insider;
- (xi) confirmation of the plan must be unlikely to be followed by liquidation or the need for further financial reorganization of the debtor or any successor thereto under the plan, unless such liquidation or reorganization is contemplated by the plan (the so-called “feasibility” standard);
- (xii) all fees payable to the U.S. Trustee must be paid in full or the plan must provide for such payment on the plan’s effective date;
- (xiii) the plan must provide for the continuation of all retiree benefits post-confirmation for the duration of the period the debtor has obligated itself to provide such benefits;
- (xiv) to the extent that the debtor is required to pay a domestic support obligation, the debtor must pay all amounts that first became payable postpetition;
- (xv) in an individual debtor case where the holder of an allowed unsecured claim has objected to confirmation, (i) the value, as of the plan’s effective date, of the property to be distributed under the plan on account of such claim must not be less than the amount of such claim or (ii) the value of the property to be distributed under the plan must not be less than the debtor’s projected disposable income to be received during the five year period commencing on the date on which the first payment under the plan is due or during the period for which the plan provides payments, whichever is longer; and
- (xvi) all transfers of property of the plan must be made in accordance with any applicable provisions of nonbankruptcy law that govern the transfer of property by a corporation or a trust that is not a moneyed, business or commercial corporation or trust.

11 U.S.C. § 1129(a).

## 2. Non-Consensual Confirmation

Although confirmation of a plan will be expedited if all classes of claims and interests have accepted the plan,<sup>82</sup> this is not a requirement. In fact, the Bankruptcy Code expressly provides for the situation where confirmation of a plan is sought over the rejection of the plan by one or more classes. Another situation in which plan confirmation can be complicated is where a debtor attempts to unimpaired a secured creditor under a plan. Finally, an issue that typically must be resolved where confirmation of a plan is non-consensual is the debtor's value. Each of these issues is discussed in turn below.

### a. Cramdown

If all of the requirements for consensual confirmation are satisfied except for acceptance of the plan by all impaired classes (see clause (viii) in Chapter VI.G.1. above), on request of the plan's proponent, the court shall confirm the plan notwithstanding the absence of this requirement, provided that the plan does not discriminate unfairly, and is fair and equitable,<sup>83</sup> with respect to each impaired class of claims and interests that has not accepted the plan. 11 U.S.C. § 1129(b)(1). This is commonly referred to as "cramdown."

Section 1129 of the Bankruptcy Code states that a plan may not "discriminate unfairly ... with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1). "Generally speaking, this standard ensures that a dissenting class will receive relative value equal to the value given to all other similarly situated classes." *In re Johns-Manville Corp.*, 68 B.R. 618, 636 (Bankr. S.D.N.Y. 1986). "The pertinent inquiry is not whether the plan discriminates, but whether the proposed discrimination is 'unfair.'" *Ownby v. Jim Beck, Inc. (In re Jim Beck, Inc.)*, 214 B.R. 305, 307 (Bankr. W.D. Va. 1997). Although the Bankruptcy Code does not define when differing treatment of similarly situated creditors is deemed to be "unfair," courts generally consider (i) whether a rationale

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<sup>82</sup> The fact that all classes have accepted a Chapter 11 plan does not mean that there will be no objections to plan confirmation, however. Even if a class has accepted the plan, individual members of that class are not barred from objecting to plan confirmation.

<sup>83</sup> The "fair and equitable" requirement is also commonly referred to as the "absolute priority rule" because it essentially requires that senior classes receive all distributions from the debtor before junior classes receive any distributions.

justifies the discrimination and (ii) whether the extent of the discrimination is narrowly tailored in light of the stated rationale.<sup>84</sup> See *In re 203 N. LaSalle St. Ltd. Pshp.*, 190 B.R. 567, 585 (Bankr. N.D. Ill. 1995).

Examples of scenarios that justified discrimination of similarly situated creditors have included (i) protecting the credit-worthiness of the debtor, see *In re Creekstone Apartments Associates, L.P.*, 168 Bankr. 639, 644 (Bankr. M.D.Tenn. 1994), (ii) satisfying other requirements of a Chapter 11 confirmation, such as the best interest test of Section 1129(a)(7) of the Bankruptcy Code, see *In re 203 N. LaSalle St. Ltd. Pshp.*, 190 B.R. at 585, (iii) preserving the good will of the debtor's most essential creditors, such as critical creditors or vendors, see *In re Kliegl Bros. Universal Elec. Stage Lighting Co.*, 149 B.R. 306, 308 (Bankr. E.D.N.Y. 1992), and (iv) when other Sections of the Bankruptcy Code allow for subordination of a creditor's claims, such as Section 510 of the Bankruptcy Code, see *In re Lernout & Hauspie Speech Prods., N.V.*, 301 B.R. 651, 662 (Bankr. D. Del. 2003).

In the context of a cramdown, the "fair and equitable" requirement is generally satisfied if the plan provides for payment in full of more senior classes (but not more than 100% of their claims or interests) before junior classes receive any value. The Bankruptcy Code contains specific requirements which must be met for a plan to be deemed fair and equitable:

- (i) with respect to a class of secured claims, the plan must provide (a) (1) that the holders of the secured claims retain the liens securing such claims, regardless of whether the underlying property is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims and (2) each holder

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<sup>84</sup> However, other courts have applied a rebuttable presumption test in which there is deemed to be unfair discrimination when there is "(1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution.' If there is an allegation of a materially lower percentage recovery, the presumption can be rebutted 'by showing that, outside of bankruptcy, the dissenting class would similarly receive less than the class receiving a greater recovery, or that the alleged preferred class had infused new value into the reorganization which offset its gain.' A demonstration that the risk allocation was similar to the risk assumed by the parties prior to bankruptcy can rebut the presumption that a discriminatory risk allocation was unfair." See, e.g., *In re Armstrong World Indus.*, 348 B.R. 111, 121 (Bankr. D. Del. 2006) (internal citation omitted).



of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim of a value, as of the plan's effective date, of at least the value of such holders' interest in the estate's interest in such property; (b) for the sale of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds thereof; or (c) for the realization by such holders of the indubitable equivalent of such claims;

- (ii) with respect to a class of unsecured claims, (a) the plan must provide that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the plan's effective date, equal to the allowed amount of such claim; or (b) 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;<sup>85</sup> and
- (iii) with respect to a class of interests, (a) the plan must provide that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the plan's effective date, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption preference to which such holder is entitled or the value of such interest; or (b) the holder of any interest that is junior to the interests of such class will not receive any property.

11 U.S.C. § 1129(b)(2).

The present value of the payments that must be made to a class of secured creditors in order to cram down a Chapter 11 plan on such class is determined by calculating the applicable interest rate. This calculation has been a source of some controversy in the courts. In 2004, the U.S. Supreme Court concluded that the formula approach (*i.e.*, starting with the market rate or prime rate adjusted for risk based on the circumstances of each case) should be utilized to determine the appropriate cramdown interest rate in a Chapter 13

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<sup>85</sup> In an individual debtor case, however, the debtor may retain any property that was acquired, or any earnings from services performed by the debtor, postpetition but prior to confirmation.

case. See *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004). Although the U.S. Supreme Court did not rule on what the appropriate cramdown interest rate would be in a Chapter 11 case, it also implied in dicta that a market approach might make sense in the Chapter 11 context. *Id.* at 477 n.14.

## ii. *New Value Exception*

In essence, the absolute priority rule requires that no junior class receive or retain any property under the proposed plan of reorganization unless all senior classes are paid in full. See *Bank of New York Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*, 584 F.3d 229, 244 n.20 (5th Cir. 2009). However, the so-called “new value exception,” a common law exception to the absolute priority rule, permits the debtor or plan proponent to include a provision in the plan whereby existing shareholders or equity holders contribute new value to the debtor’s estate in order to retain their equity interests in the reorganized entity even though one or more senior classes is not receiving payment in full under the Chapter 11 plan. Although the U.S. Supreme Court has never definitively ruled on the viability of the new value exception, it has limited the exception’s applicability by requiring such a provision to be market-tested if it is to be utilized. See *Bank of Amer. Nat’l Trust and Savings Ass’n v. 203 North LaSalle Street P’ship*, 526 U.S. 434 (1998) (assuming that a new value exception even exists, a Chapter 11 plan that granted its pre-bankruptcy partners the exclusive right to acquire equity in the reorganized entity through the contribution of new value violated the Bankruptcy Code’s absolute priority rule).

## b. Cramup

In certain situations where a secured debt carries an interest rate that is significantly lower than the current market rate and has a reasonable maturity date, the plan proponent may choose to leave that secured debt unimpaired under the plan in order to take advantage of the relatively favorable terms of such secured debt, notwithstanding the occurrence of certain breaches that would otherwise entitle the secured creditor to accelerate the debt. This is commonly referred to as “cram up.” However, when a default has occurred

that would otherwise entitle the secured creditor to accelerate its debt, the plan can only reinstate the secured debt if the plan satisfies the requirements of Section 1124(2), discussed in Chapter VI.F.3., as applicable to the secured creditor at issue.

### c. Entity Valuation

It is often necessary in the context of a nonconsensual confirmation to determine the debtor's value. See H.R. REP. NO. 595, 95th Cong., 1st Sess. 414 (1977) ("a valuation of the debtor's business . . . will almost always be required under Section 1129(b) in order to determine the consideration to be distributed under the plan."). As discussed above, the plan must be fair and equitable to each dissenting class of creditors, and the debtor will be required to demonstrate that it is not paying any class more than the allowed amount of their claims. Stated another way, if the equity class is being eliminated under the debtor's plan (which is often the case with insolvent debtors), the equity holders can force a fight over the valuation of the debtor to ensure that parties receiving distributions under the plan are not receiving more than they are due or, conversely, to ensure that existing equity is, in fact, not entitled to any distribution.

The actual process of calculating the value of a reorganized debtor, however, can be complicated. The term "value" has a host of meanings, but in the Chapter 11 context, valuation is generally grounded upon an entity's going concern value. See *In re Westpointe*, 241 F.3d 1005, 1009 (8th Cir. 2001). Two of the most common valuation methods in this context are the discounted cash flow (or DCF) analysis and the company comparables analysis. The bankruptcy court's findings with respect to entity valuation will generally be upheld (unless they are clearly erroneous) provided that acceptable valuation methods were used. See *In re Westpointe*, 241 F.3d at 1008.

## H. Post-Confirmation Matters

### 1. *Effect of Confirmation*

Subsequent to confirmation of a plan, the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan or has accepted the plan, are all bound by the provisions of such plan. 11 U.S.C. § 1141(a). Additionally, unless otherwise specified in the plan or confirmation order, confirmation of a plan vests all property of the estate in the debtor and releases it from all claims and interests of creditors, equity security holders and general partners in the debtor. 11 U.S.C. § 1141(b)–(c).

Confirmation of a plan also operates to discharge the debtor from any pre-confirmation date debts unless the plan or confirmation order provides otherwise.<sup>86</sup> 11 U.S.C. § 1141(d)(1). This discharge is effective against all such claims regardless of whether a proof of claim was filed on account of such claim, such claim was allowed or the holder of such claim voted to accept the plan.<sup>87</sup> 11 U.S.C. § 1141(d)(2). Confirmation of a plan does not discharge a debtor, however, if (i) the plan provides for the liquidation of all or substantially all of the property of the estate, (ii) the debtor ceases to engage in business after consummation of the plan *and* (iii) the debtor would be denied a discharge if the case were a case under Chapter 7.<sup>88</sup> 11 U.S.C. § 1141(d)(3). As a result of this last provision, a debtor that is not an individual (*i.e.*, a corporation or partnership) is not eligible for a discharge in a Chapter 11 liquidation. Individuals liquidating in Chapter 11, however, remain eligible for a discharge (unless they are disqualified on other grounds). The court may also approve a written waiver of discharge executed by the debtor postpetition. 11 U.S.C. § 1141(d)(4).

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<sup>86</sup> The plan also discharges the debtor from certain postpetition debts that are deemed to have arisen prepetition.

<sup>87</sup> Certain debts may be exempt from discharge in an individual debtor case. 11 U.S.C. § 523.

<sup>88</sup> See discussion of the grounds for a denial of discharge in Chapter 7 in Chapter VII.D. below.

In the case of a reorganizing corporate debtor, plan confirmation does not discharge such debtor from any debt (i) owed to a domestic governmental unit for money, property, services or an extension, renewal or refinancing of credit, to the extent it was obtained by false pretenses or misrepresentation or (ii) for a tax or customs duty with respect to which the debtor made a fraudulent return or willfully attempted to evade or defeat. 11 U.S.C. §§ 1141(d)(6), 523(a)(2)(A)–(B).

## 2. *Implementation of a Plan*

After the court confirms a Chapter 11 plan, a debtor and other parties in interest typically will work together to finalize the transactions necessary to effectuate the plan. Among other things, these transactions can include exit financing, transfers of assets, cancellation of old debt and equity and issuance of new debt and equity, all as contemplated by the particular plan. Once these transactions (and any other conditions precedent to consummation of the plan) have been completed, a plan is considered effective, and the date on which this occurs is referred to as the “effective date.”<sup>89</sup> To the extent that a particular party in interest, including the debtor, is not fulfilling its obligations in this regard, however, the court may direct such party to take any act necessary for the plan to be consummated, including executing or delivering any instrument required to effect a transfer of property contemplated by the plan. 11 U.S.C. § 1142(b).

## 3. *Third Party Releases and Injunctions*

Generally, a bankruptcy court does not have the power to release nondebtors who may be primarily or secondarily liable for any debt of a debtor. 11 U.S.C. § 524(e). Some courts, however, have adopted a more flexible approach and have exercised their equitable powers<sup>90</sup> to uphold plans

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<sup>89</sup> While not necessarily the same, it is not unusual for the “effective date” to also be considered or deemed the same as substantial consummation of the plan as defined in Section 1101(2) of the Bankruptcy Code, discussed in greater detail in Chapter VI.F.7.

<sup>90</sup> As discussed in Chapter V.E.6. above, Section 105(a) of the Bankruptcy Code authorizes courts to take actions “necessary or appropriate” to carry out the provisions of the Bankruptcy Code. Additionally, Section 1123(b)(6) permits a plan to include “any . . . appropriate provision not inconsistent with the applicable provisions of” the Bankruptcy Code.

that include releases for nondebtor entities. See, e.g., *Republic Supply Co. v. Shoaf*, 815 F.2d 1046, 1050 (5th Cir.1987) (allowing for a plan’s discharge of a guaranty where such discharge “has been accepted and confirmed as an integral part of reorganization.”). At any rate, permitting nondebtor releases is the exception rather than the rule, and, to confirm a plan that includes such a release, a debtor will need to demonstrate that the release is critical to the reorganization and is fair. See *In re Continental Airlines, Inc.*, 203 F.3d 203 (3d Cir. 2000) (referring to certain “hallmarks of permissible non-consensual releases – fairness, necessity to the reorganization, and specific factual findings to support these conclusions . . .”).

Whereas a release operates to relieve a nondebtor from liability relating to debts of a debtor, an injunction permanently enjoins a claimant from bringing an action against a third party relating to debts of a debtor. Courts are divided on the question of whether the bankruptcy court has the authority to issue permanent injunctions to protect nondebtor parties post-confirmation. Some courts interpret the Bankruptcy Code narrowly to prohibit the issuance of such injunctions, concluding that a permanent injunction would “improperly insulate nondebtors in violation of Section 524(e)” which, as discussed above, prevents the court from discharging a nondebtor from liability for a debt of the debtor. *In re W. Real Estate Fund, Inc.*, 922 F.2d 592, 602 (10th Cir. 1991). Although these courts recognize the existence of a bankruptcy court’s equitable powers under Section 105(a), they find that such powers “may not be exercised in a manner that is inconsistent with the other, more specific provisions of the [Bankruptcy] Code.” *Id* at 601. Other courts interpret Sections 524(e) and 105(a) differently. These courts find that Section 524(e) explains only the effect of a debtor’s discharge and does not prohibit enjoining a creditor’s claims against a nondebtor. They conclude that, under “unusual circumstances,” a bankruptcy court has the power under Section 105(a) to issue permanent injunctions barring actions against nondebtors. See, e.g., *In re Dow Corning Corp.*, 280 F.3d 648, 658 (6th Cir. 2002).<sup>91</sup>

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<sup>91</sup> The Sixth Circuit went on to observe that “unusual circumstances” exist when the following factors are present:

- (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate;
- (2) The non-debtor has contributed substantial assets to the reorganization;
- (3) The

#### 4. *Exemption from Securities Laws*

The Bankruptcy Code provides a limited exemption from the registration requirements of Federal and State securities law for securities issued under a plan by a debtor, an affiliate participating in a joint plan with the debtor or a successor to the debtor in exchange for a claim against or an interest in the debtor or such affiliate as well as for certain other securities. 11 U.S.C. § 1145(a). This exemption, however, is not available for any entity that is an underwriter, which, for purposes of the Bankruptcy Code, means any entity that (i) purchases a claim against, or an interest in, the debtor for the purpose of distributing any security received in exchange for such claim or interest, (ii) offers to sell securities offered or sold under the plan for the holders of such securities, (iii) offers to buy securities offered or sold under the plan from the holders of such securities for the purpose of distributing such securities and under an agreement made in connection with the plan or the consummation thereof or with the offer or sale of securities under the plan or (iv) is an issuer, as used in Section 2(11) of the Securities Act of 1933, of such securities. 11 U.S.C. § 1145(b).

#### 5. *Special Tax Provisions*

##### a. *Transfer Tax Exemption*

The issuance, transfer or exchange of a security or the making or delivery of an instrument of transfer under a confirmed plan is not subject to any laws imposing a stamp or similar transfer tax. 11 U.S.C. § 1146(a). In 2008, the U.S. Supreme Court ruled that a sale of real estate by a debtor prior to confirmation did not qualify for this tax exemption even though the sale was

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injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full; and (7) The bankruptcy court made a record of specific factual findings that support its conclusions.

*Id.*

effected as part of a global settlement with creditors and was a significant aspect of the debtor's Chapter 11 plan. The Court concluded that the Bankruptcy Code clearly required that a transfer occur after confirmation to qualify for the exemption. See *Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, 128 S.Ct. 2326 (2008). It is not clear, however, how courts will apply this exemption in the context of pre-confirmation sales or transfers that do not close until after plan confirmation. At least one court has already held that a pre-confirmation sale that closed post-confirmation was exempt from transfer taxes where the sale was necessary to consummation of the debtor's Chapter 11 plan. See *In re New 118th, Inc.*, 398 B.R. 791 (Bankr. S.D.N.Y. 2009).

### b. Net Operating Losses (NOLs)

A corporation suffering a net operating loss ("NOL") in a particular tax year may carry back or carry forward such loss to offset taxable income of certain other years. The value of a NOL depends not only on its size but also upon the amount and timing of the income that the NOL offsets. Because the U.S. government would prefer that the benefit of a NOL remain with the owners of the company that suffered the loss, Section 382(a) of the Internal Revenue Code is designed in part to limit the amount of income that can be offset by an NOL following a 50% change in its stock ownership (an "Ownership Change").

Ordinarily, the amount of a NOL that can be used against taxable income of a loss company following an Ownership Change is limited to the product of the net equity value of the company's stock and the so-called long-term tax-exempt bond rate.<sup>92</sup> Special rules, however, mitigate this limitation in bankruptcy. Specifically, Section 382(l)(5) of the Internal Revenue Code (the so-called "Bankruptcy Exception") provides that a reorganized corporation may retain the use of its NOLs (subject to certain limitations<sup>93</sup>) notwithstanding an ownership change where (i) the corporation was under the jurisdiction of a court immediately before the ownership change (such

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<sup>92</sup> The long-term tax-exempt bond rate was 4.03% for Ownership Changes occurring in May 2010.

<sup>93</sup> Corporations qualifying for the Bankruptcy Exception must reduce their amount of pre-ownership change NOLs by the amount of interest on the debt converted to equity during the bankruptcy that was paid or accrued in the three tax years preceding the ownership change (this is commonly referred to as an "interest haircut").



that an out-of-court restructuring would not qualify) and (ii) following the ownership change, at least 50% of the corporation's stock was owned by its existing shareholders, creditors that held debt of the corporation for at least eighteen months prior to the bankruptcy filing or ordinary business creditors. For purposes of this test, only the holdings of persons (or groups of related persons) holding more than 5% or more of the corporation's stock are actually counted. If there is a second ownership change within two years after the ownership change to which the Bankruptcy Exception applies, however, the Bankruptcy Exception will cease to apply. The requirements for the Bankruptcy Exception can be difficult to satisfy, particularly in a case where there has been a great deal of trading of the corporation's debt or where an acquiring entity seeks to obtain more than 50% of the corporation's stock.

Section 382(l)(6) of the Internal Revenue Code applies to corporations in bankruptcy that elect out of, or do not qualify for, the Bankruptcy Exception. This provision permits a corporation to increase its value for purposes of the Section 382 limitation by taking into account increases in the value of the corporation realized through the bankruptcy process that are attributable to the conversion of debt into stock (*i.e.*, such corporation's stock would be valued after, as opposed to before, any debt cancellation that is part of the Chapter 11 plan). Accordingly, the reorganized corporation is permitted to use NOLs in an amount equal to its reorganized value multiplied by the long-term tax-exempt bond rate. Use of Section 382(l)(6) may be preferable to the Bankruptcy Exception where Section 382's limitation on NOLs will allow the corporation to use its NOLs with sufficient speed and quantity because of the corporation's post-bankruptcy value and where the corporation expects an additional ownership change within two years.

## I. Conclusion of the Case

### 1. Closing

Once an estate has been fully administered in a Chapter 11 reorganization case, a final decree closing the case must be entered, either on motion of a party in interest or by the court *sua sponte*. 11 U.S.C. § 350(a); Fed. R. Bankr. P. 3022. Although the Bankruptcy Code does not provide any guidance for determining whether a case has been “fully administered,” an Advisory Committee Note to Bankruptcy Rule 3022 is helpful in this regard:

Entry of a final decree closing a chapter 11 case should not be delayed solely because the payments required by the plan have not been completed. Factors that the court should consider in determining whether the estate has been fully administered include (1) whether the order confirming the plan has become final, (2) whether deposits required by the plan have been distributed, (3) whether the property proposed by the plan to be transferred has been transferred, (4) whether the debtor or the successor of the debtor under the plan has assumed the business or the management of the property dealt with by the plan, (5) whether payments under the plan have commenced, and (6) whether all motions, contested matters, and adversary proceedings have been finally resolved.

Fed. R. Bankr. P. 3022, Advisory Committee Note (1991).

On motion of the debtor or another party in interest, a case may be reopened in the same court in which the case was closed in order to administer assets, to accord relief to the debtor or for other cause. 11 U.S.C. § 350(b); Fed. R. Bankr. P. 5010. The Bankruptcy Code does not define “other cause,” and thus the decision as to whether to reopen a bankruptcy case lies within the court’s discretion. *See In re Shondel*, 950 F.2d 1301, 1304 (7th Cir. 1991) (“In exercising its discretion to reopen a case, ‘the bankruptcy court should exercise its equitable powers with respect to substance and not technical considerations that will prevent substantial justice.’”) (internal

citation omitted). It should be noted that reopening the case does not provide substantive relief and is only a “ministerial or mechanical act which allows the court file to be retrieved.” *In re Suplinskas*, 252 B.R. 293, 294-95 (Bankr. D. Conn. 2000).

## 2. *Dismissal and Conversion to Chapter 7*

A debtor has the absolute right to convert its Chapter 11 case to Chapter 7 unless it has ceased to be a debtor-in-possession, the case was originally commenced as an involuntary proceeding, or the case was converted to Chapter 11 other than at the debtor’s request. 11 U.S.C. § 1112(a). Additionally, at the request of a party in interest, and after notice and a hearing, Section 1112(b) of the Bankruptcy Code provides for conversion or dismissal of a Chapter 11 case for “cause.” Sixteen examples of what constitutes “cause” are set forth in Section 1112(b)(4), but “such lists are viewed as illustrative rather than exhaustive, and the Court should ‘consider other factors as they arise.’” *In re Gateway Access Solutions, Inc.*, 374 B.R. 556, 561 (Bankr. M.D. Pa. 2007).

The 2005 Amendments amended the statutory language of Section 1112(b) from permissive to mandatory, limiting a court’s discretion to refuse to dismiss a Chapter 11 case or to convert the case to Chapter 7 (whichever is in the best interests of creditors and the estate) once it finds that “cause” exists. The initial burden lies with the moving party to establish that “cause” exists for converting or dismissing a Chapter 11 case. Once cause is established, the burden then shifts to the debtor or another objecting party to prove that unusual circumstances exist such that the relief sought (*i.e.*, conversion or dismissal of the case) would not be in the best interests of creditors and the estate. Although the Bankruptcy Code does not define “unusual circumstances” as used in Section 1112(b), “the phrase contemplates conditions that are not common in chapter 11 cases.” *In re New Towne Dev., LLC*, 404 B.R. 140, 147 (Bankr. M.D. La. 2009).

### 3. *Bad Faith Filings*

A Chapter 11 case can be dismissed for bad faith if it is clear that, on the petition date, “there was no reasonable likelihood that the debtor intended to reorganize and no reasonable probability that it would eventually emerge from bankruptcy proceedings.” *In re C-TC 9th Ave. P’ship*, 113 F.3d 1304, 1309 (2d Cir. 1997). No single factor is determinative of good faith, and courts “must examine the facts and circumstances of each case in light of several established guidelines or indicia, essentially conducting an ‘on-the-spot evaluation of the Debtor’s financial condition [and] motives.’” *In re Kingston Square Assocs.*, 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1997) (internal citation omitted). The following factors, however, have been used by bankruptcy courts to determine whether a petition was filed in bad faith:

(1) [W]hether the filing of the petition was strategically timed to obtain a litigation advantage; (2) whether the debtor’s reorganization effort is essentially a two party dispute; (3) the nature and extent of the debtor’s assets, debts and business operations; and (4) whether there is a reasonable probability that a reorganization plan can be proposed and confirmed.

*In re Squires Motel, LLC*, 416 B.R. 45, 49 (Bankr. N.D.N.Y. 2009). Bankruptcy petitions should be dismissed for bad faith, however, only if “both objective futility of the reorganization process and subjective bad faith in filing the petition are found.” *In re Kingston Square Assocs.*, 214 B.R. at 725.

# VII

LIQUIDATION (CHAPTER 7)



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## VII. Liquidation (Chapter 7)

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### A. Generally

Although liquidation of a debtor's assets can be (and often is) accomplished under other Chapters of the Bankruptcy Code, Chapter 7, which applies to both entities and individuals, is most commonly used in such a scenario. In addition to the general liquidation provisions, Chapter 7 also contains specific provisions applicable only to the liquidation of stockbrokers, commodity brokers and clearing banks.

Like a Chapter 11 reorganization proceeding, a Chapter 7 proceeding can be commenced by the filing of a bankruptcy petition with a bankruptcy court either voluntarily by a debtor or involuntarily against a debtor by a group of creditors. Furthermore, as discussed above in Chapter VI.I.2., a Chapter 7 case can also occur via conversion of a Chapter 11 proceeding to Chapter 7.<sup>94</sup>

### B. The Chapter 7 Trustee

One of the main differences between Chapter 7 and the other Chapters of the Bankruptcy Code is that in a Chapter 7 liquidation, a third party trustee is automatically appointed to oversee and administer the estate. Thus, for example, in the case of a corporation, existing management is displaced and the trustee and its advisors take over.

#### 1. *Appointment and Election of Trustee*

Promptly upon the filing of a voluntary Chapter 7 proceeding (or entry of the order for relief in an involuntary proceeding), the U.S. Trustee is required to appoint an interim trustee to protect the debtor's assets and administer the case, including, as necessary, to operate the debtor's business pending the appointment of a permanent trustee.<sup>95</sup> 11 U.S.C. § 701. The interim trustee

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<sup>94</sup> As discussed in more detail below, in Chapter VIII.H., a Chapter 13 case may also be converted to a Chapter 7 case. 11 U.S.C. § 1307.

<sup>95</sup> In the case of an involuntary proceeding, Bankruptcy Rule 2001(a) provides that an interim trustee may be appointed after the filing of the petition but prior to entry of the order for relief. However, in such an instance, the party requesting such appointment must post a bond to indemnify the debtor for any costs, attorney's fees and damages that are allowable where the court dismisses the involuntary petition other than on consent. Fed. R. Bankr. P. 2001(b); 11 U.S.C. § 303(i).

must be a disinterested person who is a member of the panel of private trustees maintained under 28 U.S.C. § 586(a)(1) or is already serving as trustee. 11 U.S.C. § 701(a)(1). If none is willing to serve, the U.S. Trustee may serve as interim trustee. 11 U.S.C. § 701(a)(2).

A permanent trustee may be elected at the meeting of creditors held pursuant to Section 341 of the Bankruptcy Code<sup>96</sup> in a Chapter 7 proceeding by those non-insider creditors holding allowable, undisputed, fixed, liquidated, general unsecured claims against the debtor and who do not have an “interest materially adverse”<sup>97</sup> to the interests of the creditors eligible to vote for a trustee. 11 U.S.C. § 702(a). In order for a trustee of the creditors’ choosing to be appointed, however, creditors holding at least 20% in amount of the eligible claims must request such appointment, at least 20% in amount of the eligible claims must actually vote and a candidate must receive votes equal to at least a majority in amount of the claims actually voted. 11 U.S.C. § 702(b)–(c). If any of these conditions are not satisfied, the interim trustee will continue as the permanent trustee. 11 U.S.C. § 702(d).

Finally, if the permanent trustee dies, resigns, fails to qualify or is removed, creditors can elect a successor trustee in the same fashion as the election of the original permanent trustee. 11 U.S.C. § 703(a). If necessary, the U.S. Trustee can appoint an interim successor trustee pending election of a permanent successor trustee. 11 U.S.C. § 703(b). If no successor trustee is elected by the creditors, the U.S. Trustee will appoint (or, if none are willing to serve, act as) a permanent successor trustee. 11 U.S.C. § 703(c).

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<sup>96</sup> See Chapter III.H.2. for a discussion of the Section 341 meeting.

<sup>97</sup> The term “interest materially adverse” is not defined in the Bankruptcy Code, but is determined based upon a variety of factors including the nature and size of the adverse interest.



## 2. *Duties and Responsibilities of Trustee*

Pursuant to Section 704 of the Bankruptcy Code, a trustee in a Chapter 7 proceeding has the following duties and responsibilities:

- (i) to collect and reduce to cash the assets of the bankruptcy estate (including any avoidance actions) and close the bankruptcy estate as swiftly as possible;
- (ii) to be accountable for all property received;
- (iii) to ensure that an individual debtor performs its intention to either claim property securing consumer debts as exempt, redeem such property or reaffirm such debts;
- (iv) to investigate the financial affairs of the debtor;
- (v) to examine proofs of claim and object to any claims that are improper;
- (vi) if advisable, to oppose the debtor's discharge;
- (vii) unless otherwise ordered by the court, to furnish to parties in interest such information concerning the bankruptcy estate and its administration as is requested by them;
- (viii) if the debtor's business is authorized to be operated, to provide to certain parties periodic reports and summaries of such operations, including a statement of receipts and disbursements;
- (ix) to make a final report and file a final account of the administration of the bankruptcy estate;
- (x) to provide notice to any claimants for domestic support obligations of the right to use the services of the State child support enforcement agency;
- (xi) to continue to perform any obligations of the debtor as the administrator of an employee benefit plan; and

- (xii) to use all reasonable and best efforts to transfer patients from a health care business that is in the process of being closed.

As a general matter, a trustee enjoys immunity from liability for actions taken by it within the scope of its official duties. See *In re Mailman Steam Carpet Cleaning Corp.*, 196 F.3d 1, 7 n.4 (1st Cir. 1999), *cert. denied*, 530 U.S. 1230 (2000). Such immunity does not extend, however, to breaches of fiduciary duty or acts of gross negligence or willful misconduct committed by a trustee in fulfilling its duties. See *id.* at 7 n.4; *In re Smyth*, 207 F.3d 758 (5th Cir. 2000); *In re Weiss*, 111 F.3d 1159, 1168-69 (4th Cir. 1997), *cert. denied*, 522 U.S. 950 (1997).

### C. Collection, Liquidation and Distribution of the Estate

Although the main purpose of a Chapter 7 proceeding is to dispose of the debtor's property and to distribute the proceeds collected to the debtor's creditors as swiftly as possible, this does not mean that the trustee is required to instantly shut down the debtor's operations. In fact, Section 721 of the Bankruptcy Code specifically provides that a trustee is authorized to operate the debtor's business for a limited period of time "if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate."<sup>98</sup> Any operation of the debtor's business by the trustee, however, must comply with both applicable State law and Federal, State and local tax law. 28 U.S.C. §§ 959(b), 960(a). Furthermore, a trustee can be sued in connection with its actions in "carrying on business" connected with the estate's property. 28 U.S.C. § 959(a). The operation of the debtor's business can include the obtaining of credit under Section 364 of the Bankruptcy Code and the use, sale or lease of property under Section 363 of the Bankruptcy Code. The trustee is also permitted to assume or reject executory contracts and unexpired leases pursuant to Section 365 of the Bankruptcy Code. Finally, the trustee is authorized to prosecute avoidance actions in order to assist in the collection of the debtor's assets.

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<sup>98</sup> For a discussion of the principles governing operation of a debtor's business in bankruptcy see Chapter VI.C. above.

Once the debtor's property has been collected and converted to cash, the trustee is obligated to distribute such cash to the debtor's creditors in accordance with the statutory priority scheme set forth in Section 726 of the Bankruptcy Code, as follows: (i) administrative expense claims and unsecured priority claims in the order set forth in Section 507 of the Bankruptcy Code (both timely filed claims and certain tardily filed claims),<sup>99</sup> (ii) general unsecured claims (both timely filed and certain tardily filed claims), (iii) the remaining tardily filed general unsecured claims, (iv) allowed secured and unsecured claims for fines, penalties and forfeitures and for punitive damages, arising before the earlier of the order for relief or the appointment of the trustee, in each case to the extent such amount is not compensation for actual pecuniary loss suffered by the creditor, (v) postpetition interest on the foregoing and (vi) the debtor. 11 U.S.C. § 726(a). Within each priority level, distributions are to be made *pro rata*. 11 U.S.C. § 726(b).

One caveat to the foregoing hierarchy is that secured claims are paid out first from the underlying collateral to the extent they are not otherwise voidable. See *United Sav. Ass'n. v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 370 (1988). Another caveat to the foregoing is that, where the Chapter 7 case resulted from the conversion of a case under another Chapter, the Chapter 7 administrative expenses have priority over the administrative expenses incurred in the prior case. 11 U.S.C. § 726(b).

## D. Discharge of the Debtor and Denial of Discharge

Upon conclusion of a Chapter 7 case, an individual debtor is generally entitled to receive an order discharging his or her prepetition debts. There are two exceptions to this entitlement. One, where the debtor has committed, or refused to perform, certain acts, the debtor is denied a discharge in bankruptcy. That denial of discharge leaves the debtor liable for all of his or her debts. Second, where an individual debtor has committed certain acts related to specific creditors, the debtor is denied a discharge with respect to the claims of those specific creditors. Those claims are referred to as non-dischargeable.<sup>100</sup>

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<sup>99</sup> See discussion of priority claims at Chapter V.D.2.c., above.

<sup>100</sup> These specific types of claims are generally non-dischargeable in Chapters 7, 11, 12 or 13.

Section 727 of the Bankruptcy Code provides that the court shall not grant the debtor a discharge where any of the following grounds exist:

- (i) the debtor is not an individual;
- (ii) the debtor, with intent to hinder, delay or defraud a creditor, transferred, removed, destroyed, mutilated or concealed property of the debtor within one year before the petition date, or property of the estate after the petition date;
- (iii) the debtor has concealed, destroyed, mutilated, falsified or failed to keep or preserve any recorded information from which the debtor's financial condition or business transactions can be ascertained, unless justified under all of the circumstances of the case;
- (iv) the debtor knowingly and fraudulently, in or in connection with the case (a) made a false oath or account, (b) presented or used a false claim, (c) gave, offered, received or attempted to obtain money, property or advantage for acting or forbearing from acting or (d) withheld from an officer of the estate any information relating to the debtor's property or financial affairs;
- (v) the debtor has failed to explain satisfactorily, before determination of denial of discharge, any loss or deficiency of assets;
- (vi) the debtor has refused, in the case (a) to obey any lawful order of the court (other than an order to respond to a material question or testify), (b) on the ground of privilege against self-incrimination, to respond to a material question approved by the court or to testify, after the debtor has been granted immunity with respect to the matter concerning which such privilege was invoked or (c) on a ground other than the properly invoked privilege against self-incrimination, to respond to a material question approved by the court or to testify;

- (vii) the debtor committed any acts specified in paragraphs (ii) through (vi) above on or within one year before the petition date, or during the case, in connection with another case concerning an insider;
- (viii) the debtor received a discharge in a case under Chapter 7 or 11 (or the corresponding Section of the Bankruptcy Act) which was commenced within eight years before the petition date;
- (ix) the debtor received a discharge in a case under Chapter 12 or 13 (or the corresponding Section of the Bankruptcy Act) which was commenced within six years before the petition date, unless payments under the plan in the previous case totaled at least (a) 100% of the allowed unsecured claims or (b) 70% of such claims and the plan was proposed in good faith and was the debtor's best effort;
- (x) the court approves a written waiver of discharge executed by the debtor after the order for relief under Chapter 7;
- (xi) after filing the Chapter 7 case, an individual debtor fails to complete an instructional course in personal financial management; or
- (xii) the court finds that there is reasonable cause to believe that (a) Section 522(q)(1) of the Bankruptcy Code (which prevents individuals who have engaged in criminal conduct from shielding their homestead assets from those whom they have defrauded or injured) may apply to the debtor and (b) there is pending any proceeding in which the debtor may be found guilty of a felony or liable for a debt of the kinds described in Section 522(q)(1).

11 U.S.C. § 727(a)–(b). Of particular note, although individuals who are liquidating under Chapter 7 can receive a discharge (provided that no other ground for denial of a discharge is applicable to them), corporations and other entities who are liquidating under Chapter 7 cannot.

Parties in interest, including creditors, the trustee and the U.S. Trustee, may object to the granting of a discharge and can also request revocation of a discharge. 11 U.S.C. § 726(c)–(d). As a general matter, if granted, the discharge both eliminates the debtor’s personal liability for all non-exempt debts and enjoins creditors from attempting to collect such debts. Many courts have construed the discharge provisions favorably to debtors. See, *Republic Credit Corp. I v. Boyer (In re Boyer)*, 328 Fed. Appx. 711 (2d Cir. 2009).

The procedures governing matters related to discharge, including the grant or denial of discharge, objections to discharge and the burden of proof related thereto, are set forth in Bankruptcy Rules 4004 through 4007.

## E. Non-Dischargeable Debts

As stated above, where an individual debtor has committed certain acts with respect to the debts of specific creditors, the relevant debts may be excepted from discharge. The non-dischargeable debts are specified in Section 523 of the Bankruptcy Code and include debts:

- (i) for taxes or customs duties entitled to priority under Section 507(a)(3) or (a)(8), whether or not a claim was filed or allowed, with respect to which (a) a return, if required, was not filed, was filed late and within two years before the petition date or was made fraudulently or (b) the debtor willfully attempted to evade such tax;
- (ii) for money, property, services or an extension, renewal or refinancing of credit if obtained by (a) false pretenses, a false representation or actual fraud (other than a statement respecting the debtor’s or an insider’s financial condition) or (b) an intentional written statement respecting the debtor’s or an insider’s financial condition that is materially false and on which the applicable creditor reasonably relied;<sup>101</sup>

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<sup>101</sup> Certain consumer debts for luxury goods or services are presumed to be non-dischargeable under this sub-section.

- (iii) that are neither listed nor scheduled with the name, if known to the debtor, of the creditor to whom such debt is owed in time to permit (a) if the debt is not of a kind specified in paragraphs (2), (4) or (6) of Section 523, timely filing of a proof of claim (unless such creditor had notice or actual knowledge of the case in time for such timely filing) or (b) if the debt is of a kind which is specified in paragraphs (2), (4) or (6), timely filing of a proof of claim and timely request for a determination of dischargeability of such debt (unless such creditor had notice or actual knowledge of the case in time for such timely filing);
- (iv) for fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny;
- (v) for domestic support obligations;
- (vi) for willful and malicious injury by the debtor to another entity or such entity's property;
- (vii) for fines, penalties or forfeitures payable to and for the benefit of a governmental unit, which are not compensation for actual pecuniary losses, other than penalties (a) relating to taxes of a kind not specified in paragraph (i) above or (b) imposed for an event that occurred more than three years before the petition date;
- (viii) for educational loans made, insured or guaranteed by a governmental unit (or under any program funded in whole or in part by a governmental unit or nonprofit entity) or scholarships or stipends obligated to be paid, in each case unless excepting such debt from discharge would impose an undue hardship on the debtor and its dependants;
- (ix) for death or personal injury caused by the debtor's illegal operation of a motor vehicle, vessel or aircraft when intoxicated from using alcohol, drugs or another substance;
- (x) that were, or could have been, listed or scheduled by the debtor in a prior bankruptcy case in which the debtor waived or was denied (for certain specified reasons) a discharge;

- (xi) provided for in a final judgment, unreviewable order, consent order or decree or settlement agreement arising from an act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union;
- (xii) for malicious or reckless failure to fulfill any commitment by the debtor to a Federal depository institution's regulatory agency to maintain the capital of an insured depository institution, except if any such commitment would otherwise be terminated due to any act of such agency;
- (xiii) for any payment of an order of restitution issued in connection with a criminal matter under Title 18 of the United States Code;
- (xiv) incurred to pay certain nondischargeable taxes or to pay fines or penalties imposed under Federal election law;
- (xv) to a debtor's spouse, former spouse or child, other than those described in paragraph (v) above, incurred in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other court order or a determination by a governmental unit in accordance with State or territorial law;
- (xvi) for postpetition fees or assessments to a condominium, cooperative or homeowners association if incurred for a period of time when the debtor had a legal, equitable or possessory ownership interest in the entity governed by such association, subject to a specified exception;
- (xvii) for certain court fees imposed on a prisoner;
- (xviii) for certain loans owed to certain qualified pension, profit-sharing, stock bonus or other similar plans; and



- (xix) for (a) violations of Federal and State securities laws or regulations or (b) common law fraud, deceit or manipulation in connection with the purchase or sale of a security, in each case which results from a judgment, order or settlement agreement, whether entered, or entered into, pre- or postpetition.

## F. Stockbroker, Commodity Broker and Clearing Bank Liquidations

In addition to the standard liquidation rules set forth in Chapter 7, Chapter 7 contains specialized rules for the liquidation of stockbrokers (Subchapter III of Chapter 7; 11 U.S.C. §§ 741–753), commodity brokers (Subchapter IV; 11 U.S.C. §§ 761–767) and certain clearing banks (Subchapter V; 11 U.S.C. §§ 781–784). These types of entities are not eligible for Chapter 11 reorganization, and can only commence Chapter 7 proceedings under the Bankruptcy Code, although, at least in the case of stockbrokers, there are other liquidation procedures available outside of the Bankruptcy Code.

### 1. *Stockbrokers*

Stockbrokers can liquidate under either Subchapter III of Chapter 7 of the Bankruptcy Code or outside of the Bankruptcy Code pursuant to the Securities Investor Protection Act of 1970, otherwise known as “SIPA” (codified at 15 U.S.C. §§ 78aaa *et seq.*). Although similar in many respects, stockbroker liquidations under the Bankruptcy Code and under SIPA have some significant substantive and procedural differences.

As an initial matter, a main difference between a stockbroker liquidation and the liquidation of a typical company is the addition of the concept of customers and the need to deal with assets held by the debtor for the account of a customer (*i.e.*, “customer property” and “customer name securities”).

A customer is an:

(i) entity with whom a person deals as principal or agent and that has a claim against such person on account of a security received, acquired, or held by such person in the ordinary course of such person's business as a stockbroker, from or for the securities account or accounts of such entity (a) for safekeeping; (b) with a view to sale; (c) to cover a consummated sale; (d) pursuant to a purchase; (e) as collateral under a security agreement; or (f) for the purpose of effecting registration of transfer; and (ii) entity that has a claim against a person arising out of (a) a sale or conversion of a security received, acquired or held as specified in subparagraph (i) of this paragraph; or (b) a deposit of cash, a security, or other property with such person for the purpose of purchasing or selling a security.

11 U.S.C. § 741(2).

Under both Chapter 7 and SIPA, customers are treated as a separate class of creditors and, to the extent of the customer property, are given priority over the stockbrokers' general creditors. Customer property is property held by or on behalf of the debtor for the securities account of a particular customer. 11 U.S.C. § 741(4). Under both Chapter 7 and SIPA, the customers share the pool of customer property *pro rata*. A customer's *pro rata* share of the pool of customer property is based on such customer's "net equity" claim. 11 U.S.C. § 752(a). This claim is determined essentially through a netting of amounts owed between the customer and the stockbroker. 11 U.S.C. § 741(6). To the extent that customer property is insufficient to repay customer claims in full, customers are also entitled to share in the debtor's general asset pool on a *pro rata* basis with general creditors. 11 U.S.C. § 752(b)(2). Conversely, any excess customer property after satisfaction of customer net equity claims is distributed to the debtor's other creditors in accordance with the general priority scheme of Section 726. 11 U.S.C. § 752(b)(1).

Both the Bankruptcy Code and SIPA include special provisions for “customer name securities,” which are securities that are not held in “street name” but rather are (i) held for a customer’s account on the petition date, (ii) registered (or in the process of being registered) in such customer’s name and (iii) not in a form transferable by delivery on such date. 11 U.S.C. § 741(3). Such securities may be excluded from the customer property pool, and, upon satisfaction of any negative net equity balance, a customer is entitled to return of its customer name securities. 11 U.S.C. §§ 748, 751.

Section 748 of the Bankruptcy Code provides that all securities held by the debtor as property of the estate, other than customer name securities, are to be liquidated consistent with market practice as soon as practicable after the bankruptcy filing. This would include any securities that are customer property. 11 U.S.C. § 750. Thus, in a Chapter 7 liquidation, all securities (other than customer name securities) are to be promptly reduced to cash (with such cash distributed to customers and general creditors, as applicable). In a SIPA liquidation, however, the SIPA trustee is required, to the greatest extent possible, to distribute actual securities to the customers entitled to them. 11 U.S.C. §§ 748, 750; 15 U.S.C. § 78fff-1(b)(1). In fact, in certain circumstances in a SIPA liquidation, the SIPA trustee may be required to purchase securities for distribution to customers. 15 U.S.C. § 78fff-2(d). Moreover, a SIPA trustee may effectuate a bulk transfer of customer accounts to another member of the Securities Investor Protection Corporation (or “SIPC”) with the approval of SIPC, but without the need for customer consent. 15 U.S.C. § 78fff-2(f). This mechanism enables a SIPA trustee to expeditiously satisfy customer net equity claims, while minimizing possible customer market losses arising from the customer’s inability to trade securities in its account during the pendency of the proceeding.<sup>102</sup>

Procedurally, a SIPA proceeding differs from a Chapter 7 case in that, rather than the filing by the debtor of a petition with a bankruptcy court, a SIPA liquidation is commenced when SIPC files an application and complaint in Federal district court. Such a filing by SIPC automatically stays any

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<sup>102</sup> In addition, customers in a SIPA proceeding are at least partially protected from shortfalls in customer property through payments from the SIPC reserve fund. Some broker-dealers have purchased insurance coverage (e.g. CAPCO) for customer losses above the SIPC coverage limits.

liquidation proceeding previously commenced by the debtor under Chapter 7. 11 U.S.C. § 742; 15 U.S.C. § 78eee(b)(2)(B)(i). Once the Federal district court enters a protective decree in the SIPA liquidation and appoints a SIPA trustee, the SIPA liquidation is moved from the district court to the bankruptcy court. 15 U.S.C. § 78eee(b)(4).

## *2. Commodity Brokers*

Chapter 7 of the Bankruptcy Code also provides some special provisions for the liquidation of a commodity broker (11 U.S.C. §§ 761–767), but these liquidations are largely governed by the Commodity Exchange Act and certain regulations enacted by the Commodity Futures Trading Commission. Generally, these provisions require the trustee to promptly transfer or liquidate open commodity contracts, and establish a customer priority in customer property that is broadly analogous to the stockbroker provisions.

## *3. Clearing Banks*

Finally, certain “clearing banks” are authorized to liquidate under Chapter 7 in specified circumstances. 11 U.S.C. §§ 781–784.

# G. Conclusion of the Case

## *1. Generally*

Typically, a Chapter 7 case concludes when all of the debtor’s assets have been liquidated and the proceeds thereof have been distributed to creditors. Unlike in Chapter 11, no plan is promulgated in a Chapter 7 case. Similar to a Chapter 11 case, however, upon conclusion of a Chapter 7 case, a final decree must be entered and the case must be closed in accordance with Section 350 of the Bankruptcy Code and Bankruptcy Rule 3022, as discussed above in Chapter VI.I.

## 2. Conversion and Dismissal

Similar to a Chapter 11 case, a Chapter 7 case can be converted to a case under another Chapter of the Bankruptcy Code, although the debtor must be eligible for relief under the particular Chapter to which conversion is sought. 11 U.S.C. § 706(d). There are two methods for conversion of a Chapter 7 case. First, upon the request of a debtor only, a Chapter 7 case can be converted to a case under any of Chapters 11, 12 or 13. 11 U.S.C. § 706(a). Notice and a hearing is not required when the request is made under Section 706(a), although a hearing can be required by the court. *See* Fed. R. Bankr. P. 1017(f)(2). However, a debtor can only request conversion under Section 706(a) if the case has not previously been converted under Sections 1112, 1208 or 1307 of the Bankruptcy Code. 11 U.S.C. § 706(a). Although such relief is generally considered mandatory as long as the requirements of Section 706(a) are met, the U.S. Supreme Court has held that conversion under Section 706(a) can be denied when the subsequent case would be subject to immediate dismissal. The Court, however, indicated that such denial should be limited to extreme situations. *See Marrama v. Citizens Bank*, 549 U.S. 365 (2007).

Second, any party in interest, including the debtor, can request conversion under Section 706(b). Under this Section, there is no requirement that the case not have been previously converted from another Chapter, however, conversion under Section 706(b) is limited to Chapter 11. Further, conversion under Section 706(b) is expressly subject to notice and a hearing. Consistent with Sections 706(a) and (b), Section 706(c) explicitly provides that a conversion to Chapters 12 or 13 can only be made at the request, or with the consent, of the debtor.

Also, similar to Chapter 11 cases, Chapter 7 cases may be dismissed. 11 U.S.C. § 707(a). However, unlike conversion, the ability of a court to dismiss a Chapter 7 case is constrained. In particular, a request for dismissal is subject to notice and a hearing and may be “only for cause.” *Id.* Examples of cause set forth in Section 707(a) include: (i) unreasonable delay by the debtor that prejudices creditors; (ii) nonpayment of certain fees or charges; and (iii) failure of the debtor to timely file certain information with the court in a voluntary case. *Id.*

Finally, Section 707(b) authorizes a court to either dismiss or, with the consent of the debtor, convert a Chapter 7 case for an individual debtor whose debts are primarily consumer debts where the court determines that the granting of relief under Chapter 7 (typically the discharge) would be an abuse of the provisions of Chapter 7. This is discussed in more detail above in Chapter IV.A.2.a.

# VIII

ADJUSTMENT OF DEBTS OF AN INDIVIDUAL WITH  
REGULAR INCOME (CHAPTER 13)





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## VIII. Adjustment of Debts of an Individual with Regular Income (Chapter 13)

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### A. Background

Chapter 13 provides for the adjustment of debts of an individual with regular income, and it allows a debtor to keep certain assets (as opposed to Chapter 7, which requires debtors to surrender most of their assets) and to repay out of his or her future income all or a portion of his or her debts over time, usually three to five years. Chapter 13 is sometimes referred to as a “wage earner’s reorganization” and offers individuals several advantages over a Chapter 7 liquidation. For example, Chapter 13 debtors may be able to protect their homesteads because Chapter 13 allows them to cure home mortgage defaults until such time as the underlying residences are sold at foreclosure sales. Additionally, Chapter 13 enables debtors to reschedule their secured debts and extend them over the life of the Chapter 13 plan, which may reduce the monthly or periodic payment amounts. Finally, the discharge granted to a Chapter 13 debtor is somewhat broader than that granted to a debtor under Chapter 7.

### B. Chapter 13 Debtors

An individual with regular income, or an individual with regular income and his or her spouse, may file for bankruptcy under Chapter 13 so long as such individual owes (i) noncontingent, nonliquidated, unsecured debts in the amount of \$360,475 or less and (ii) noncontingent, nonliquidated, secured debts in the amount of \$1,081,400 or less. 11 U.S.C. § 109(e).<sup>103</sup> In determining whether an individual has “regular income” under Chapter 13, courts should consider the stability and regularity of such income rather than its type or source. *See, e.g., Barbosa v. Soloman*, 235 F.3d 31, 38 (1st Cir. 2000). As described in greater detail above in Chapter IV.A.2.b., in Chapter 13, a means test is used to determine the length of the debtor’s plan and the amount of payments to unsecured creditors under such plan. Additionally, any individual seeking relief under Chapter 13 must have received from an approved nonprofit budget and credit counseling agency an individual or

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<sup>103</sup> Stockbrokers and commodity brokers are excluded from Chapter 13.

group briefing that outlines the opportunities available for credit counseling and assistance in performing a related budget analysis. Each of these must have occurred in the 180 days preceding the filing of the individual's Chapter 13 petition. 11 U.S.C. § 109(h).

Notwithstanding the foregoing, no individual may be a debtor under Chapter 13 if such individual has been a debtor under any Chapter of the Bankruptcy Code in the preceding 180 days and (i) the case was dismissed by the court for the debtor's willful failure to abide by court orders or to appear before the court in proper prosecution of the case or (ii) the debtor requested and obtained the voluntary dismissal of the case after a request for relief from the automatic stay was filed in such case. 11 U.S.C. § 109(g).

### C. Automatic Stay

Under Chapter 13, once the automatic stay is in place, creditors are precluded from taking action to collect a consumer debt<sup>104</sup> against an individual, or the property of such individual, who is also liable for that debt unless such individual became liable on or secured the debt in the ordinary course of his business or if the case is closed, dismissed or converted to Chapter 7 or 11. 11 U.S.C. § 1301(a). This provision is designed to insulate the Chapter 13 debtor from any pressures his creditors may attempt to exert through friends or relatives that have cosigned any of the debtor's obligations. On request of a party in interest, and after notice and a hearing, relief from the codebtor stay shall be granted to the extent that (i) the codebtor received the consideration for the debt, (ii) the Chapter 13 plan proposes not to pay such debt or (iii) the creditor's interest would be irreparably harmed by continuation of the codebtor stay under clause (ii) above. 11 U.S.C. § 1301(c). Twenty days after a party files a request for relief from the codebtor stay, such stay will be automatically terminated unless the debtor or the codebtor files and serves an objection to such request. 11 U.S.C. § 1301(d).

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<sup>104</sup> The Bankruptcy Code defines a "consumer debt" as a "debt incurred by an individual primarily for a personal, family or household purpose." 11 U.S.C. § 101(8).

## D. Rights and Powers of Chapter 13 Trustee and Debtor

Similar to a case under Chapter 7 of the Bankruptcy Code (discussed above in Chapter VII.), Section 1302 of the Bankruptcy Code provides that, upon commencement of a Chapter 13 case, a trustee is to be appointed to oversee the case. Unlike in a Chapter 7 case, however, the trustee in a Chapter 13 case does not replace the debtor, but instead works with the debtor to administer the case. Sections 1302(b) and (c) set forth the duties of a Chapter 13 trustee. To a large extent, these duties are similar to those of a Chapter 7 trustee (discussed in greater detail in Chapter VII.B.). 11 U.S.C. § 1302(b)(1). However, the Chapter 13 trustee holds fewer responsibilities than other trustees and only generally monitors the case and ensures that the basic rules in a Chapter 13 case are adhered to.

Although the principal administrator in a Chapter 13 case is the Chapter 13 trustee, the debtor has the exclusive powers of a trustee under Section 363 with respect to the use, sale and lease of property of the estate other than in the ordinary course of business. 11 U.S.C. § 1303. This Section should not be construed, however, to mean that the debtor does not possess other powers concurrently with the Chapter 13 trustee. *See, e.g., Cable v. Ivy Tech State College*, 200 F.3d 467 (7th Cir. 1999) (holding that a Chapter 13 debtor has standing to file, prosecute and appeal a cause of action belonging to the estate). Unless the confirmed plan or confirmation order provides otherwise, the Chapter 13 debtor remains in possession of all property of the estate. 11 U.S.C. § 1306(b). Chapter 13 differs slightly from Chapter 7, however, in that the property of the estate in a Chapter 13 case includes not only all property of the estate as provided in Section 541 (see discussion above in Chapter V.B.1.), but also all property acquired, and all earnings from services performed, by the debtor after the commencement of the bankruptcy case. 11 U.S.C. § 1306(a).

## E. Chapter 13 Plan

The debtor has the exclusive right to file a plan under Chapter 13. 11 U.S.C. § 1321. The length of a debtor's plan varies between three and five years. A Chapter 13 debtor's plan may not provide for payments over a period of time that is longer than five years if the current monthly income of the debtor and his spouse combined is greater than the applicable State median family income for a family of equal or lesser size. 11 U.S.C. § 1322(d)(1). The debtor's plan may not provide for payments over a period of time that is longer than three years, unless the court, for cause, approves a longer period (although the court cannot approve a period that is longer than five years) if the current monthly income of the debtor and his spouse combined is less than the applicable State median family income for a family of equal or lesser size. 11 U.S.C. § 1322(d)(2).

### *1. Mandatory Plan Provisions*

Every Chapter 13 plan is required to:

- (i) provide for the submission to the trustee of all or such portion of the debtor's future earnings or income as is necessary for the plan's execution;
- (ii) provide for the full payment, in deferred cash payments, of all priority claims unless the holder of a particular claim agrees to a different treatment of such claim;
- (iii) if the plan classifies claims, provide the same treatment for each claim within a particular class; and
- (iv) notwithstanding the foregoing, provide for less than full payment of all amounts owed for a domestic support obligation only if the plan provides that all of the debtor's projected disposable income for a five-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

11 U.S.C. § 1322(a).

## 2. *Permissive Plan Provisions*

In addition to the mandatory provisions described above, a Chapter 13 plan may also:

- (i) designate an administrative convenience class (see discussion in Chapter VI.F.2. above) but may not discriminate unfairly against any such class (provided that the plan may treat claims for a consumer debt differently than other unsecured claims if there is a codebtor for such consumer debt);
- (ii) modify the rights of holders of secured claims, other than a claim secured by a mortgage on the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;
- (iii) provide for the curing or waiving of any default;
- (iv) provide for payments on any unsecured claim to be made concurrently with payments on any secured claim or any other unsecured claim;
- (v) notwithstanding paragraph (ii) above, provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured or secured claim on which the final payment is due after the date on which the final plan payment is due;
- (vi) provide for payment of all or any part of a postpetition claim for taxes that becomes payable during the pendency of the case or for a consumer debt for property or services necessary for the debtor's performance under the plan;
- (vii) provide for the assumption, rejection or assignment of any executory contract or unexpired lease of the debtor not previously rejected by the debtor;
- (viii) provide for the payment of all or part of a claim against the debtor from property of the estate or property of the debtor;

- (ix) provide for the vesting of property of the estate in the debtor or any other entity upon confirmation of the plan or at a later time;
- (x) provide for the payment of postpetition interest on unsecured, nondischargeable claims, provided that such interest may only be paid to the extent that the debtor has disposable income available to pay such interest after making provision for full payment of all allowed claims; and
- (xi) include any other appropriate provision that is not inconsistent with the Bankruptcy Code.

11 U.S.C. § 1322(b). If, as discussed above, a plan proposes to cure a default, the amount necessary to cure such default shall be determined in accordance with the underlying contract and applicable nonbankruptcy law. 11 U.S.C. § 1322(e).

### *3. Treatment of Mortgages on the Debtor's Primary Residence*

Although Section 1322(b)(2) provides that a plan may not modify the rights of a holder of a secured claim where such claim is secured by a mortgage on the debtor's principal residence (see paragraph (ii) in Chapter VIII.E.2. above), the debtor may modify the terms of his residential mortgage under the plan so long as the final payment on the original payment schedule is due prior to the final payment under the debtor's plan.<sup>105</sup> 11 U.S.C. § 1322(c)(2). Additionally, the debtor is permitted to cure a default on the mortgage for his primary residence at least through such time as the residence is sold at a foreclosure sale that is conducted in accordance with applicable nonbankruptcy law. 11 U.S.C. § 1322(c)(1). The legislative history indicates that Section 1322(c)(1) is intended to be permissive rather than restrictive. Thus, if a State provides a debtor with more extensive "cure" rights than what is in the Bankruptcy Code, the debtor would still be entitled to those rights in bankruptcy.

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<sup>105</sup> The plan will also have to comply with the confirmation requirements with respect to secured creditors in Section 1325(a)(5) of the Bankruptcy Code, discussed below in Chapter VIII.F.2.

#### 4. *Pre-Confirmation Modification of the Plan*

The debtor may modify a Chapter 13 plan at any time prior to confirmation so long as the modified plan, which becomes the plan once it has been filed, complies with the requirements of Section 1322 (see discussion above). 11 U.S.C. § 1323(a)–(b). A secured creditor’s original acceptance or rejection of the plan remains binding after the filing of a modified plan unless the modification provides for a change in the rights of such creditor from what they were under the plan prior to modification and such holder changes its vote. 11 U.S.C. § 1323(c).

### F. Confirmation of Plan

#### 1. *Confirmation Hearing*

A confirmation hearing is required in Chapter 13 cases, and any party in interest may object to the plan. 11 U.S.C. § 1324(a). The confirmation hearing may be held not earlier than twenty days and not later than forty-five days after the date of the Section 341 meeting of creditors (discussed above in Chapter III.H.2.) unless the court determines that it would be in the best interests of creditors and the estate to hold the hearing at an earlier date and there is no objection to such earlier date. 11 U.S.C. § 1324(b).

As in a Chapter 11 case, when the court finds that the plan satisfies all confirmation requirements, it will enter an order confirming the plan. However, such an order may be revoked on request of a party in interest, after notice and a hearing, at any time before 180 days after the date the confirmation order was entered. 11 U.S.C. § 1330(a). The court may only revoke the confirmation order if it finds that the order was procured by fraud. *Id.*<sup>106</sup>

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<sup>106</sup> If the court revokes the confirmation order, it must convert or dismiss the Chapter 13 case unless the plan is modified appropriately. 11 U.S.C. § 1330(b).

## 2. *Confirmation Requirements*

The court is required to confirm a debtor's Chapter 13 plan if the following requirements are satisfied:

- (i) the plan complies with the provisions of Chapter 13 and with the other applicable provisions of the Bankruptcy Code;
- (ii) any fee, charge or bankruptcy fee and any amounts required by the plan to be paid before confirmation have been paid;
- (iii) the plan has been proposed in good faith and not by any means prohibited by law;
- (iv) the value of property to be distributed under the plan on account of each allowed unsecured claim is not less than what the holder of such claim would receive in a Chapter 7 liquidation (the "best interests test");
- (v) the debtor will be able to make all payments under the plan and to comply with the plan (the "feasibility test");
- (vi) the debtor's filing of the Chapter 13 petition was in good faith;
- (vii) the debtor has paid all amounts that are required to be paid under a domestic support obligation and that first became payable postpetition if the debtor is legally required to pay such domestic support obligation; and
- (viii) the debtor has filed all applicable Federal, State and local tax returns.

11 U.S.C. § 1325(a).



In addition, Section 1322(a)(5) provides special rules for the treatment of secured claims in Chapter 13 which must be met in order for a plan to be confirmed. These rules require that, with respect to each allowed secured claim provided for by the plan, the plan will only be confirmed if:

- (i) the holder of such claim has accepted the plan;
- (ii) (a) the plan provides that the holder of such claim retains the lien securing such claim; (b) the value, as of the plan's effective date, of the property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; and (c) if the property to be distributed on account of such claim is in the form of periodic payments, such payments shall be in equal monthly amounts, and if the holder of the claim is secured by personal property, the amount of such payments shall not be less than an amount sufficient to provide adequate protection to such holder during the period of the plan; or
- (iii) the debtor surrenders the property securing such claim to such holder.

11 U.S.C. § 1325(a)(5). If the plan provides for a secured creditor to retain its lien (*see* Section 1325(a)(5)(B)(i)), such lien shall be retained until the earlier of the payment of the underlying debt under nonbankruptcy law or the debtor receives a discharge under Chapter 13; if the Chapter 13 case is dismissed or converted prior to the debtor's completion of the plan, such lien shall be retained by such holder to the extent permitted by applicable nonbankruptcy law.

The 2005 Amendments exempt certain claims from the provisions of Section 1325(a)(5). More specifically, Section 1325(a) provides that, for purposes of Section 1325(a)(5), Section 506 of the Bankruptcy Code, discussed in Chapter V.D.2.b., shall not apply if a creditor has a purchase money security interest securing a debt incurred within the 910-day period preceding the petition date and the collateral for such debt is (i) the debtor's personal motor vehicle or (ii) any other thing of value, if the debt was

incurred during the one-year period preceding the bankruptcy filing. The result of this provision is that the exempted claims remain secured claims, but the debtor does not get the benefit of Section 1325(a)(5).<sup>107</sup>

As set forth above, a plan proponent will be permitted to “cram down” the plan over the objection of a secured creditor so long as the requirements of Section 1325(a)(5) are met, including the present value of distributions. As discussed in Chapter VI.G.2.a. above, the calculation of the present value of the payments that must be made to a class of secured creditors in order to cram down a Chapter 13 plan requires the court to determine the appropriate interest rate to apply to such payments. In 2004, the U.S. Supreme Court concluded that the formula approach (i.e., starting with the market rate or prime rate adjusted for risk based on the circumstances of each case) should be utilized to determine the appropriate cramdown interest rate in a Chapter 13 case. See *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).

### 3. *Objections to Confirmation*

If the trustee or a holder of an unsecured claim objects to plan confirmation, then the court may not confirm the plan unless, as of the effective date, (i) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim or (ii) the plan provides that all of the debtor’s projected disposable income to be received during the length of the plan period will be applied to make payments to unsecured creditors under the plan. 11 U.S.C. § 1325(b)(1). For purposes of the foregoing provisions, “disposable income” is defined to mean current monthly income received by the debtor (with certain exceptions)<sup>108</sup> less the amounts reasonably necessary to be expended for the maintenance or support of the debtor or one of his dependents, charitable contributions to qualified institutions, and, to the extent the debtor is engaged in business, amounts for the payment of expenditures necessary for the continuation, preservation and operation of such business. 11 U.S.C. § 1325(b)(2). If the debtor’s currently monthly income exceeds the applicable State median income for his household size, then the “amounts reasonably necessary to be expended”

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<sup>107</sup> It should be noted that secured claims may still be modified pursuant to Section 1322(b)(2), discussed above in Chapter VIII.E.2.

<sup>108</sup> These exceptions include child support payments, foster care payments or disability payments for a dependent child.

under Section 1325(b)(2) must be determined in accordance with subparagraphs (A) and (B) of Section 707(b)(2) (see discussion in Chapter IV.A.2.a. above). If the debtor's currently monthly income is below the applicable State median income for his household size, the calculation of his expenses will largely be determined by the court's judgment of whether such expenses are reasonable.

#### 4. *Plan Payments*

Unless the court orders otherwise, the debtor must begin making payments under the plan not later than thirty days after the date of the filing of the plan or the order for relief, whichever is earlier. 11 U.S.C. § 1326(a)(1). Plan payments must be in the amount (i) proposed by the plan to the trustee, (ii) scheduled in a lease of personal property directly to the lessor for that portion of the obligation that becomes due postpetition, or (iii) that provides adequate protection directly to a creditor holding a claim secured by personal property to the extent the claim is attributable to the purchase of such property. *Id.* Payments made to the trustee shall be retained by the trustee pending confirmation or denial of confirmation. 11 U.S.C. § 1326(a)(2). If the plan is confirmed, the trustee shall distribute such payments in accordance with the plan as soon as practicable. *Id.* If the plan is not confirmed, the trustee generally must return to the debtor payments that are not yet due and owing to creditors of the debtor. *Id.* Before any payments are made to creditors in a Chapter 13 case, any unpaid administrative expense claims and certain fees relating to trustees<sup>109</sup> must be paid. 11 U.S.C. § 1326(b). Although the general rule is that, unless otherwise provided in the plan or the confirmation order, the trustee shall make payments to creditors under the plan, a Chapter 13 debtor is permitted to make payments directly to his creditors. 11 U.S.C. § 1326(c); see *In re Mendoza*, 111 F.3d 1264 (5th Cir. 1997).

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<sup>109</sup> If a standing Chapter 13 trustee is serving in the case, his fee must be paid. Additionally, limited payments to a Chapter 7 trustee may be due in certain circumstances if the debtor was previously a debtor in a Chapter 7 case that was dismissed or converted.

## 5. *Post-Confirmation Modification of the Plan*

At any time after plan confirmation but prior to the completion of plan payments, the plan may be modified, upon request of the debtor, the trustee or the holder of an allowed unsecured claim, to (i) increase or reduce the amount of payments on claims of a particular class under the plan, (ii) extend or reduce the time of such payments, (iii) alter the amount of the distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim by means other than under the plan, or (iv) in certain circumstances, reduce amounts to be paid under the plan to permit the debtor to purchase health insurance for the debtor or one of his dependents. 11 U.S.C. § 1329(a). Although a showing of a substantial change in the debtor's financial condition after confirmation may warrant modification of the debtor's plan, Section 1329 does not include any express threshold requirement for modification, and most courts have been loath to read one into the statute. See *Roberts v. Boyajian (In re Roberts)*, 279 B.R. 396, 400 (B.A.P. 1st Cir. 2000).

## G. Effect of Confirmation and Discharge

### 1. *Effect of Confirmation*

A confirmed Chapter 13 plan is binding on the debtor and each creditor, whether or not the claims of such creditors are provided for by the plan, and whether or not such creditors have objected to, accepted or rejected the plan. 11 U.S.C. § 1327(a). Furthermore, except as otherwise provided for in the plan or confirmation order, confirmation of a Chapter 13 plan vests all property of the estate in the debtor free and clear of any claim or interest of any creditor provided for by the plan. 11 U.S.C. § 1327(b)–(c).

### 2. *Discharge*

Unless the court approves a postpetition written waiver of discharge executed by the debtor, a Chapter 13 debtor is entitled to a discharge of all debts provided for by the plan or disallowed under Section 502 of the Bankruptcy Code<sup>110</sup> (with certain exceptions discussed below) as soon as

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<sup>110</sup> Section 502 is discussed in Chapter V.D.5. above.

practicable after completion of all payments under the plan<sup>111</sup> so long as the debtor has (i) not received a discharge in a case filed under Chapter 7, 11 or 12 of the Bankruptcy Code in the four years preceding the petition date or under Chapter 13 of the Bankruptcy Code in the two years preceding the petition date and (ii) completed an instructional course concerning personal financial management. 11 U.S.C. § 1328. The following debts, however, are non-dischargeable in a Chapter 13 case:

- (i) any debt with respect to which the final payment is not due until after the date on which the final payment under the plan is due;
- (ii) certain tax claims;
- (iii) any claim for money, property, services or an extension, renewal or refinancing of credit obtained by false pretenses;
- (iv) any claim not listed in the debtor's schedules or list of creditors where the holder of such claim lacked notice or actual knowledge of the debtor's bankruptcy case so as to be able to timely file a proof of claim;
- (v) any claim for fraud or defalcation while the debtor was acting in a fiduciary capacity, embezzlement or larceny;
- (vi) domestic support obligations;
- (vii) educational loans made, insured or guaranteed by a governmental unit or scholarships or stipends obligated to be paid (unless excepting such debt would impose an undue hardship on the debtor and its dependants);
- (viii) any debt for death or personal injury caused by the debtor's illegal operation of a motor vehicle, vessel or aircraft while intoxicated;
- (ix) any debt for restitution or a criminal fine included in a sentence imposed upon the debtor's conviction of a crime; or

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<sup>111</sup> Where applicable, a Chapter 13 debtor may also need to certify that all required domestic support obligations have been paid.

- (x) any debt for restitution or damages awarded in a civil action against the debtor as a result of willful or malicious injury by the debtor that caused personal injury or death to an individual.

11 U.S.C. § 1328(a). Additionally, a Chapter 13 debtor is not discharged from any postpetition consumer debt for property or services necessary for the debtor's performance under the plan if prior approval by the trustee of the debtor's incurring of such debt was practicable, but was not obtained. 11 U.S.C. § 1328(d).

The court may grant a so-called "hardship discharge" to a debtor that has not completed payments under the plan only if (i) "the debtor's failure to complete such payments is due to circumstances for which the debtor should not justly be held accountable," (ii) the value, as of the plan's effective date, of property actually distributed under the plan on account of each allowed unsecured claim is not less than the amount that would have been paid on such claim in a hypothetical Chapter 7 liquidation of the debtor, and (iii) modification of the plan is not practicable. 11 U.S.C. § 1328(b). Most courts take a fairly strict view of the hardship discharge and limit its application to compelling circumstances. See *In re White*, 126 B.R. 542 (Bankr. N.D. Ill. 1991). Other courts take a more lenient approach and allow a hardship discharge "due to economic circumstances that did not exist nor were foreseeable at the time of confirmation of the plan, where those circumstances are beyond the debtor's control, and where the debtor has made every effort to overcome those circumstances but is unable to complete his plan payments." *In re Edwards*, 207 B.R. 728 (Bankr. N.D. Fl. 1997). Under either standard, however, the circumstances warranting a hardship discharge cannot have been present at the time of plan confirmation. A debtor receiving a hardship discharge is released from all unsecured debts provided for by the plan or disallowed under Section 502 of the Bankruptcy Code except any debt (i) with respect to which the final payment is not due until after the date on which the final payment under the plan is due and (ii) for which the debtor would be denied a discharge if the case were a case under Chapter 7 (the so-called "non-dischargeable debts," discussed above in Chapter VII.E.). 11 U.S.C. § 1328(c).

A party in interest may seek the revocation of a Chapter 13 debtor's discharge within the one-year period following the court's grant of such discharge. 11 U.S.C. § 1328(e). After notice and a hearing, the court may revoke the debtor's discharge only if such discharge was obtained by the debtor through fraud and the requesting party did not know of such fraud until after the discharge had been granted. *Id.*

## H. Conversion or Dismissal

A Chapter 13 debtor enjoys the absolute right to convert his case to Chapter 7 at any time (with one exception discussed below). 11 U.S.C. § 1307(a). Additionally, provided that the case has not been converted from Chapter 7, 11 or 12, a Chapter 13 debtor may move to dismiss his bankruptcy case at any time. 11 U.S.C. § 1307(b). Any waiver of these rights of the Chapter 13 debtor to convert or dismiss his case is unenforceable. *Id.*

On request of a party in interest or the U.S. Trustee, and after notice and a hearing, the court may convert a Chapter 13 case to Chapter 7 or dismiss a Chapter 13 case, whichever is in the best interest of creditors and the estate, for cause, including:

- (i) unreasonable delay by the debtor that is prejudicial to creditors;
- (ii) nonpayment of any bankruptcy fees or charges;
- (iii) failure to timely file a Chapter 13 plan;
- (iv) failure to commence making timely payments under a Chapter 13 plan;
- (v) denial of confirmation of a Chapter 13 plan and denial of a request for additional time in which to file another plan or a modification of a plan;
- (vi) material default by the debtor with respect to a term of a confirmed Chapter 13 plan;
- (vii) revocation of the Chapter 13 confirmation order and denial of confirmation of a modified Chapter 13 plan;

- (viii) termination of a confirmed Chapter 13 plan by reason of the occurrence of a condition specified in the plan other than completion of payments thereunder;
- (ix) only on request of the U.S. Trustee, the debtor's failure to file within fifteen days (or such longer period as the court may allow) after the filing of the case certain information required by paragraphs (1) and (2) of Section 521;<sup>112</sup> or
- (x) the debtor's failure to pay any domestic support obligation that first becomes payable after the petition date.

11 U.S.C. § 1307(c). Additionally, at any time prior to confirmation, on request of a party in interest or the U.S. Trustee, and after notice and a hearing, the court may convert a Chapter 13 case to Chapter 11 or 12. 11 U.S.C. § 1307(d). If a Chapter 13 debtor fails to file all tax returns for all taxable periods ending during the four-year period preceding the petition date by no later than the day before the date of the Section 341 meeting of creditors,<sup>113</sup> the court shall dismiss the case or convert it to Chapter 7, whichever is in the best interests of creditors and the estate. 11 U.S.C. § 1307(e).

Notwithstanding the foregoing, a Chapter 13 case may not be converted to any other Chapter of the Bankruptcy Code unless the debtor is eligible to be a debtor under such Chapter. 11 U.S.C. § 1307(g). Thus, even though a Chapter 13 debtor otherwise enjoys an absolute right to convert to Chapter 7, if he or she fails the Chapter 7 means test (see discussion above in Chapter IV.A.2.A.), he or she will not be permitted to convert his case to Chapter 7.

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<sup>112</sup> See discussion in Chapter IV.C.2.

<sup>113</sup> See discussion of the Section 341 meeting of creditors in Chapter III.H.2.



# IX

ANCILLARY AND OTHER CROSS-BORDER CASES  
(CHAPTER 15)



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## IX. Ancillary and Other Cross-Border Cases (Chapter 15)

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### A. Purpose of Chapter 15

As part of the 2005 Amendments, Congress enacted a new chapter of the Bankruptcy Code, Chapter 15, to deal with cross-border bankruptcy matters. Chapter 15 essentially tracks the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law, and is intended to encourage cooperation between the United States of America (the “U.S.”) and other nations with respect to cross-border insolvency cases. 11 U.S.C. § 1501(a).

Prior to the 2005 Amendments, cross-border bankruptcy matters were dealt with in Section 304 of the Bankruptcy Code. Section 304, however, had a limited scope in that it only applied to proceedings brought in the U.S. by foreign representatives in aid of duly recognized foreign proceedings. Chapter 15, on the other hand, is more expansive and applies where (i) a non-U.S. court or foreign representative seeks assistance in the U.S. in connection with a pending foreign bankruptcy case, (ii) a U.S. bankruptcy case is pending and assistance is sought in another country in connection with the U.S. case, (iii) the same debtor is subject to both a U.S. and a foreign proceeding, and (iv) non-U.S. creditors or other interested persons have an interest in commencing or participating in a U.S. bankruptcy case. 11 U.S.C. § 1501(b).

Unlike former Section 304 of the Bankruptcy Code, which has been held to apply to entities even if they did not qualify as debtors under Section 109 of the Bankruptcy Code, Chapter 15 generally only applies to entities which qualify under Section 109, although there are certain exceptions to this. See 11 U.S.C. § 1501(c). Examples of parties excluded from Chapter 15 relief include (i) stockbrokers and commodity brokers subject to Chapter 7, (ii) entities subject to Securities Investor Protection Act proceedings, and (iii) other entities excluded from U.S. bankruptcy relief under Section 109(b) (e.g., railroads, domestic (but not foreign) insurance companies, U.S. or foreign banks and certain other kinds of financial institutions). *Id.* Chapter 15 relief is also not available with respect to any deposit, escrow, trust fund or other security required or permitted under any applicable U.S. State insurance law or regulation for the benefit of U.S. claim holders. 11 U.S.C. § 1501(d).

## B. Petition for Recognition of Foreign Proceeding

Under Chapter 15, a foreign proceeding is defined as:

[A] collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

11 U.S.C. § 101(23).

Chapter 15 provides for recognition of two forms of foreign proceedings—foreign main proceedings (“a foreign proceeding pending in the country where the debtor has its center of main interests” (11 U.S.C. § 1502(4))) and foreign nonmain proceedings (“a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment” (11 U.S.C. § 1502(5))). As discussed below, there are some differences in effect under Chapter 15 between foreign main and foreign nonmain proceedings. In either case, however, before a Chapter 15 case can proceed, the foreign proceeding must be recognized by the U.S. court as either a foreign main or foreign nonmain proceeding.

As an initial matter, Section 1506 of the Bankruptcy Code permits a U.S. court to refuse to take an action under Chapter 15 (including recognition) if “the action would be manifestly contrary to the public policy of the US,” which has been interpreted to limit the bankruptcy court’s power under this Section to those situations involving the most fundamental policies of U.S. law. *See, e.g., In re RSM Richter Inc. v. Aguilar (In re Ephedra Products Liability Litig.)*, 349 B.R. 333, 336 (Bankr. S.D.N.Y. 2006).

To apply for recognition, the foreign representative<sup>114</sup> must merely file a petition for recognition together with certified evidence of the existence of

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<sup>114</sup> A foreign representative is defined as “a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor’s assets or affairs or to act as a representative of such foreign proceeding.” 11 U.S.C. § 101(24). The use of the word “body” would suggest an intention to include a debtor’s board of directors where the board is authorized to administer the foreign proceeding.

the foreign proceeding and the appointment of the foreign representative (or, in the absence of such certified evidence, such other evidence of those facts as is acceptable to the U.S. bankruptcy court). 11 U.S.C. § 1515(a)–(b). The petition for recognition must also be accompanied by a statement setting forth all foreign proceedings in respect of the debtor and known by the foreign representative. 11 U.S.C. § 1515(c). Sections 1516(a) and (b) provide for certain presumptions that serve to ease the recognition process.

The act of filing a petition for recognition, even prior to approval thereof, provides a bankruptcy court with the ability to grant certain relief, including: (i) prohibiting execution against the debtor’s assets; (ii) authorizing the foreign representative or other entity to administer or realize upon the debtor’s U.S. assets in order to avoid the diminution in value thereof; (iii) prohibiting the transfer, hypothecation or disposal of the debtor’s assets; and (iv) granting most other relief available to a trustee. 11 U.S.C. § 1519. Of particular note, however, the court cannot authorize the foreign representative to exercise the avoiding powers provided under the Bankruptcy Code. *Id.* Further, the relief under Section 1519 can only be granted if it is urgently needed to protect the debtor’s assets or the interests of the creditors. *Id.* The filing of a petition for recognition, however, does not subject the foreign representative to the jurisdiction of any other U.S. court for any other purpose. 11 U.S.C. § 1510.<sup>115</sup>

In order for a foreign proceeding to be recognized, (i) the foreign proceeding must qualify as such, (ii) the foreign representative must be a person or a body, and (iii) the petition for recognition must meet the requirements of Section 1515. 11 U.S.C. § 1517(a). As noted above, recognition under Section 1517 is subject to the public policy exception of Section 1506.

It has been held that in order for recognition to be granted, the foreign proceeding must be recognized as either a foreign main proceeding or a foreign nonmain proceeding. *See In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122 (Bankr. S.D.N.Y. 2007). This requires the foreign representative to demonstrate that the debtor has either its “center of main interests” or an “establishment” in the country in which the foreign proceeding is pending. *Id.* If neither of these can be demonstrated, then no recognition can be granted. *Id.*

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<sup>115</sup> As discussed below, once the petition is granted, the foreign representative has the capacity to sue or be sued in a U.S. court.

### 1. Foreign Main Proceeding: Center of Main Interests (COMI)

Although used in the definition of foreign main proceeding, the term “center of main interests” (or “COMI”) is itself not defined in the Bankruptcy Code. Instead, there is a presumption in the Bankruptcy Code that, in the absence of evidence to the contrary, a debtor’s COMI is its registered office or, in the case of an individual, his or her habitual residence. 11 U.S.C. § 1516(c). Notwithstanding this presumption, however, at least some U.S. bankruptcy courts have required the foreign representative seeking recognition to produce evidence of the location of the debtor’s COMI even in the absence of any opposition to the request for recognition rather than permitting bare reliance on the presumption. See, e.g., *In re Bear Stearns*, 374 B.R. at 127-31; *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37 (Bankr. S.D.N.Y. 2008).

In the absence of any explicit direction from the Bankruptcy Code, the bankruptcy courts have developed a series of factors to aid in the determination of a debtor’s COMI. These factors include the locations of the debtor’s headquarters, managers, primary assets and majority of creditors and the jurisdiction whose law would primarily apply. See *In re Basis Yield*, 381 B.R. at 47 (citing *In re Sphinx, Ltd.*, 351 B.R. 103, 117 (Bankr. S.D.N.Y. 2006), *aff’d*, 371 B.R. 10 (S.D.N.Y. 2007)). These courts have also equated COMI to a company’s “principal place of business” under U.S. law. See, e.g., *Bear Stearns*, 374 B.R. at 129.

### 2. Foreign Nonmain Proceeding: Establishment

Unlike center of main interests, the Bankruptcy Code defines “establishment” as “any place of operations where the debtor carries out a non-transitory economic activity.” 11 U.S.C. § 1502(2). Thus, in order for a foreign proceeding to be recognized as a nonmain proceeding, the debtor must have an office in the country in which the foreign proceeding is pending. It is not sufficient that the debtor only have assets in such country.

## C. Effects of Recognition of Foreign Proceeding

### 1. *Relief in the Chapter 15 Proceeding*

The relief available in a Chapter 15 proceeding, while still broad, is narrower than in a plenary U.S. bankruptcy proceeding. This is especially true for a foreign nonmain proceeding, as certain types of relief are only available if the foreign proceeding is recognized as a foreign main proceeding. For example, although the automatic stay applies in a Chapter 15 proceeding, it only does so in a foreign main proceeding and only applies to property within the territorial jurisdiction of the U.S. 11 U.S.C. § 1520(a)(1). Similarly, provisions regarding the use, sale or lease of the debtor's property also apply, but again only in a main proceeding and only with respect to property within the territorial jurisdiction of the U.S. 11 U.S.C. § 1520(a)(2).

In addition to the foregoing, the bankruptcy court also has the discretion to authorize certain relief to protect the debtor's assets, as well as the interests of creditors, whether or not the foreign proceeding is main or nonmain. 11 U.S.C. § 1521. Certain of these mirror those forms of relief available at the time of filing of the petition for recognition. However, the threshold for granting such relief is lower once recognition has been granted in that there must only be a need for such relief and not an urgent need. Relief under Section 1521 (and Section 1519, discussed above), however, may only be granted, modified or terminated if the interests of interested parties, including the debtor and creditors, are sufficiently protected. 11 U.S.C. § 1522(a). Furthermore, the court can condition the granting of such relief as it deems appropriate. 11 U.S.C. § 1522(b).

Finally, Section 1507 provides the bankruptcy court with a catch-all provision that permits it to grant additional assistance (beyond the forms of relief specified in other Sections of Chapter 15) under either the Bankruptcy Code or other U.S. laws. There are a number of elements that must be met first, however, including that such relief is consistent with the principles of comity.<sup>116</sup> 11 U.S.C. § 1507(b). An example of additional relief that a court

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<sup>116</sup> The U.S. Supreme Court has defined comity as the "recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws." *Hilton v. Guyot*, 159 U.S. 113, 164 (1895).

has granted under Section 1507 is an order to enforce a foreign court's order in U.S. bankruptcy courts. See *In re Metcalfe & Mansfield Alternative Invs.*, 421 B.R. 685 (Bankr. S.D.N.Y. 2010). Additionally, although a Chapter 15 debtor is barred from availing itself of the preferential transfer provisions of the Bankruptcy Code (unless it pursues a plenary bankruptcy case under another Chapter of the Bankruptcy Code), one bankruptcy court has stated that Section 1507 might allow a foreign representative to pursue a preferential transfer action under foreign law in a Chapter 15 bankruptcy. See *In re Atlas Shipping A/S*, 404 B.R. 726, 744 n.16 (Bankr. S.D.N.Y. 2009).

## 2. Relief Outside the Chapter 15 Proceeding

In addition to the relief noted above, recognition also provides a foreign representative with (i) the ability to (A) commence an involuntary U.S. bankruptcy case against the debtor or (B) in the case of a foreign main proceeding only, commence a voluntary U.S. bankruptcy case for the debtor and (ii) standing in a plenary U.S. bankruptcy case for the debtor to initiate certain actions to avoid acts detrimental to creditors (most notably, the exercise of avoiding powers). 11 U.S.C. §§ 1511, 1523.

Furthermore, once recognition is granted, the foreign representative (a) has the capacity to sue and be sued in a U.S. court and (b) may apply directly to a U.S. court for appropriate relief. 11 U.S.C. § 1509(b)(1)–(2). Finally, the foreign representative may also “intervene in any proceedings in a State or Federal court in the United States in which the debtor is a party” and is entitled to participate as a “party in interest” in a U.S. bankruptcy proceeding regarding the debtor. 11 U.S.C. §§ 1524, 1512.

To a large extent, this is a change from prior Section 304, which did not require the commencement of an ancillary proceeding in order for the foreign representative to take certain actions in U.S. courts with respect to the debtor. One exception to the new regime is found in Section 1509(f), which permits a foreign representative to commence a collection action without first filing a petition for, or gaining, recognition of a foreign proceeding.

One potential consequence of the new rule is that, when combined with the new venue rules for ancillary proceedings (discussed above in Chapter II.B.2.), it may require the foreign representative to commence a Chapter 15 case in a venue a long distance from the venue in which the action in which it seeks to intervene is pending.



## D. Involvement of U.S. Bankruptcy Estate Abroad

As noted above, unlike prior Section 304, Chapter 15 also addresses the situation where the representative of a U.S. bankruptcy estate, such as a trustee or examiner, seeks to act abroad on behalf of the U.S. bankruptcy estate. In particular, any such action is only permitted with the authorization of the U.S. court. 11 U.S.C. § 1505.

## E. Coordination of Concurrent U.S. and Foreign Proceedings

Chapter 15 contains various provisions dealing with concurrent proceedings in the U.S. and abroad. For example, once a foreign main proceeding has been recognized, a plenary case on behalf of the same debtor may be commenced in the U.S. if the debtor has assets in the U.S., although the bankruptcy court's jurisdiction will be limited to the debtor's assets located in the U.S. 11 U.S.C. § 1528. Chapter 15 also sets forth various guidelines for a U.S. court when coordinating a concurrent U.S. case and foreign proceeding. See 11 U.S.C. §§ 1529, 1530. Of particular note, subject to the rights of secured creditors or rights *in rem*, a creditor who receives payment in a foreign proceeding may not receive a distribution on the same claim in a U.S. case if the distribution in the U.S. case to other creditors of the same class is proportionally less than the payment such creditor received in the foreign proceeding. 11 U.S.C. § 1532.

## F. Cooperation with Non-U.S. Courts and Foreign Representatives

Consistent with its purpose, Chapter 15 contains a number of provisions intended to foster cooperation between the U.S. court and estate representatives, on the one hand, and the non-U.S. court and foreign representatives, on the other. See 11 U.S.C. §§ 1525(a), 1526(a). Among other things, the U.S. court is expressly authorized to “communicate directly with, or to request information or assistance directly from, a foreign court or foreign representative, subject to the rights of a party in interest to

notice and participation.” 11 U.S.C. § 1525(b). Similarly, a U.S. representative authorized by the U.S. court to participate in a foreign proceeding may communicate directly with the non-U.S. court or foreign representative. 11 U.S.C. § 1526(b).

# X

ADJUSTMENT OF DEBTS OF A MUNICIPALITY  
(CHAPTER 9)



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## X. Adjustment of Debts of a Municipality (Chapter 9)

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### A. Overview and Purpose of Chapter 9

Chapter 9 of the Bankruptcy Code governs municipality bankruptcies. It is the only Chapter under which a municipality may seek bankruptcy protection and, likewise, it applies solely to municipality bankruptcies.

The purpose of Chapter 9 is to afford a financially distressed public entity protection from creditors while it develops a plan for reorganizing its debts. Debt adjustment is most often accomplished in Chapter 9 by extending maturities, reducing principal or interest, or paying off some or all of the existing debt through a new loan.

The power of a bankruptcy court in Chapter 9 proceedings is limited by the sovereign powers guaranteed to the states under the Tenth Amendment of the U.S. Constitution and such limitations are reflected within the bankruptcy statute. *See U.S. v. Bekins*, 304 U.S. 27 (1937).

Notably, Chapter 9 differs from the other Chapters in that there is no provision for liquidation of the assets and distribution of the proceeds to creditors which could violate the Tenth Amendment. Chapter 9 filings have been relatively rare, perhaps because of the reluctance of governmental entities to cede any control to the bankruptcy court.

### B. Eligibility to be a Chapter 9 Debtor

Section 109(c) of the Bankruptcy Code sets forth the eligibility requirements to file for protection under Chapter 9. The statute requires that a Chapter 9 debtor be a municipality and Section 101(40) of the Bankruptcy Code defines municipality as a “political subdivision or public agency or instrumentality of a State.” The term covers a broad spectrum of entities, including cities, villages, towns, counties, boroughs, public improvement districts, school districts, and bridge and highway authorities and other revenue producing bodies that provide services paid for by the users. *See In re County of Orange*, 183 B.R. 594, 601 (Bankr. C.D. Cal. 1995).<sup>117</sup>

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<sup>117</sup> Of note, however, while the term “State” as defined in the Bankruptcy Code includes the District of Columbia and Puerto Rico, it specifically carves out the District of Columbia and Puerto Rico from eligibility under Chapter 9 of the Bankruptcy Code. 11 U.S.C. §

In addition, Section 109(c) requires that a Chapter 9 debtor:

- (i) be “specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter”;
- (ii) be insolvent;<sup>118</sup>
- (iii) “desire[] to effect a plan to adjust [its] debts; and”
- (iv) that it:
  - (a) “has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
  - (b) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
  - (c) is unable to negotiate with creditors because such negotiation is impracticable; or
  - (d) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 [*i.e.*, a preference] of [the Bankruptcy Code].”

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101(52). Thus, municipalities of the District of Columbia and Puerto Rico are not eligible for relief under Chapter 9.

<sup>118</sup> See discussion of insolvency in Chapter IV.A.3. above.

## C. Commencement of a Case

A Chapter 9 proceeding may be commenced only by the filing of a voluntary petition. Unlike cases filed under other Chapters in which the clerk of the court automatically assigns a bankruptcy judge, upon a Chapter 9 filing, Section 921(b) provides that the chief judge of the court of appeals in the governing circuit will designate the bankruptcy judge to conduct the case. 11 U.S.C. § 921(b).

Section 923 of the Bankruptcy Code requires that notice of the commencement of the Chapter 9 case (as well as notice of an order for relief or dismissal of case) be given to creditors and also be made by publication. Pursuant to Section 921(c), objections to the petition are permitted and are to address whether the Chapter 9 debtor has met the eligibility requirements of Section 109(c) and whether the petition was filed in good faith. Often objections will challenge whether the State approved the municipality to file and whether negotiations were conducted in good faith. Under Section 921(c), the bankruptcy court is required to hold a hearing, upon notice, in response to any objections and may dismiss the petition if it finds the petition was not filed in good faith or the debtor did not meet the eligibility requirements of Section 109(c). Section 921(d) requires that if the petition is not dismissed, the court must enter an order for relief. Further, Section 921(e) provides that notwithstanding an appeal of an order for relief, the bankruptcy court cannot delay or stay the bankruptcy proceeding.

## D. Applicability of Automatic Stay and Certain Other Sections of the Bankruptcy Code

Only the provisions in Chapters 1 and 9 of the Bankruptcy Code apply to Chapter 9 cases, except that Section 901 makes numerous other Sections of the Bankruptcy Code applicable in a Chapter 9 case, including, most notably, the automatic stay provisions of Section 362.<sup>119</sup> The stay is critical to the Chapter 9 proceeding in that it operates to stop all collection actions against

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<sup>119</sup> We refer to the text of Section 901 of the Bankruptcy Code for a full list of the other Sections of the Bankruptcy Code that are applicable in a Chapter 9 proceeding. Although only certain of these Sections are discussed in this chapter of the Guide, all of the significant Sections are discussed in the Guide.

the debtor and affords the municipality breathing room to develop a plan. The stay protections are expanded by Section 922(a)(1) to prohibit actions against inhabitants and officers of the debtor that seek to enforce a claim against the debtor. It should be noted, however, that the stay protections do not affect the application of special pledged revenues to payment of indebtedness secured by such revenues. 11 U.S.C. § 922(d). Among the other provisions of the Bankruptcy Code made applicable in Chapter 9 proceedings are (i) Sections 364(c)–(f) concerning the obtaining of credit and the incurring of debt, (ii) Section 365 governing the assumption and rejection of executory contracts and unexpired leases, and (iii) various Sections of Chapter 11 related to the plan and plan confirmation.

### E. Court’s Limited Power

In recognition of the sovereign powers of the States, the bankruptcy court’s powers in a Chapter 9 proceeding are severely limited and the bankruptcy court’s involvement in the debtor’s affairs and in the conduct of the case will typically be far less than in a Chapter 11 reorganization. Section 903 specifically reserves to the State continued powers to control the municipality and Section 904 guards against the court’s interference with the operations of the debtor.

In particular, Section 904 provides that, unless the debtor consents or the plan so provides, the court cannot interfere with

- (1) any of the political or governmental powers of the debtor;
- (2) any of the property or revenues of the debtor; or
- (3) the debtor’s use or enjoyment of any income-producing property.

Thus, the primary functions of the court are to (i) approve the petition (if the debtor is eligible), (ii) confirm a plan of debt adjustment, and (iii) oversee implementation of the plan.



The court also has the power to dismiss the petition at a time other than when it is considering whether to enter an order for relief. Pursuant to Section 930(a), the court may dismiss the petition for cause such as:

- (i) lack of prosecution;
- (ii) unreasonable delay by the debtor which is prejudicial;
- (iii) failure to timely propose or confirm a plan;
- (iv) material default by the debtor under a confirmed plan; or
- (v) termination of the confirmed plan due to the occurrence of a condition specified in the plan.

Furthermore, the bankruptcy court shall dismiss a Chapter 9 case if confirmation of a Chapter 9 plan is refused. 11 U.S.C. § 930(b).<sup>120</sup>

The role of the U.S. Trustee is likewise limited in a Chapter 9 proceeding. Although the U.S. Trustee can appoint a creditors' committee, it does not examine the debtor at a meeting of creditors, nor does it have the power to move for appointment of a trustee, to convert a case, to monitor the debtor's financial operations or to review professional fees.

## F. Powers of the Debtor

The Chapter 9 debtor has broad powers to use its property and make expenditures as it sees fit. See *In re Addison Community Hosp. Auth.*, 175 B.R. 646, 649 (Bankr. E.D. Mich. 1994). It has the same avoiding powers as other debtors and the same ability to reject or adjust burdensome contracts. The municipal debtor has the ability to borrow money during the case as an administrative expense. See *In re Sanitary & Improv. Dist. No. 7*, 96 B.R. 966, 967 (Bankr. D. Neb. 1989).

The court is not given authority to review the amount of debt the municipality incurs in the ordinary course of its operations. See *id.* Likewise, the court does not oversee the debtor's retention of professionals or payment of their fees except in the context of plan confirmation. See *id.*

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<sup>120</sup> There is an apparent inconsistency between Sections 930(a) and 930(b) as to whether dismissal of a case due to failure to confirm a Chapter 9 plan is permissive or mandatory.

Further, the debtor may, but is not required to, pay some or all of its prepetition obligations during the course of the bankruptcy—even prior to confirming a plan.

## G. Creditors in a Municipal Bankruptcy

### 1. *Role of Creditors*

The role of creditors is more limited in a Chapter 9 proceeding than in cases under the other Chapters. Creditors cannot file a plan of debt adjustment and there is no meeting of creditors.

There is, however, a creditors' committee which functions like a Chapter 11 creditors' committee. Its duties include consulting with the debtor concerning the administration of the case, investigating the acts, conduct, assets, liabilities and financial condition of the debtor and participating in plan formulation. The committee can employ professionals to represent it.

### 2. *Claims*

A municipal debtor is required to file a list of creditors under Section 924. Typically, the list will be filed with the petition, but the court can fix a different time if the debtor is unable to file the list at the time of the bankruptcy filing. The court fixes a bar date for the filing of claims. A creditor need not file a proof of claim if it agrees with the way its claim is scheduled on the list of creditors, unless the claim is scheduled as contingent, disputed or unliquidated, in which case a proof of claim must be filed. 11 U.S.C. § 925.

### 3. *Bondholders*

General obligation bonds are considered general debts and the municipality is not required to make payments thereon during the case and can seek to restructure them under a plan. By contrast, under Section 928, special revenue bonds will continue to be secured and serviced during the course of the case through the application and payment of ongoing special revenue, if available. Neither general obligation nor special revenue bondholders are subject to preference liability with respect to prepetition payments on account of bonds or notes. 11 U.S.C. § 926(b).

## H. Chapter 9 Plan

Section 941 of the Bankruptcy Code requires that the debtor file a plan for adjustment of its debts and provides that if the plan is not filed with the petition, it shall be filed at such time as the court fixes. There is no provision permitting a creditor or other party in interest to file a plan. A Chapter 9 debtor is permitted to modify a plan at any time before confirmation as long as the modified plan meets the requirements of Chapter 9. 11 U.S.C. § 942. Upon modification, the modified plan becomes the plan. *Id.*

### I. Plan Confirmation

A plan must meet the confirmation requirements set forth in Section 943(b), which also incorporates certain Chapter 11 confirmation standards made applicable under Section 901(a). The court is required to confirm a plan if the following conditions are met:

- (i) the plan complies with the provisions of title 11 made applicable by Sections 103(e) and 901;
- (ii) the plan complies with the provisions of Chapter 9;
- (iii) all amounts to be paid by the debtor or by any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable;
- (iv) the debtor is not prohibited by law from taking any action necessary to carry out the plan;
- (v) except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that on the effective date of the plan, each holder of an administrative claim as specified in Section 507(a)(2) will receive on account of such claim cash equal to the allowed amount of such claim;
- (vi) any regulatory or electoral approval necessary under applicable non-bankruptcy law in order to carry out any provision of the

plan has been obtained, or such provision is expressly conditioned on such approval; and

- (vii) the plan is in the “best interests” of creditors and is “feasible.”

11 U.S.C. § 943(b). In the Chapter 9 context, “best interests of creditors” is generally interpreted to mean that the plan is better than other alternatives available to creditors and “feasible” is interpreted to include an analysis of not only whether the debtor can pay prepetition debts, but also whether it can provide future public services in its status as a municipality. See *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 35 (Bankr. D. Colo. 1999).

In addition, many of the confirmation requirements of Section 1129 are required under Chapter 9. See 11 U.S.C. § 901(a). Most significantly:

- (i) the plan has to be accepted by each class of claims or interests impaired under the plan;
- (ii) at least one class of impaired creditors must have accepted the plan; and
- (iii) if only one impaired class accepts, the “cramdown” provisions of Section 1129(b) must be satisfied.

Through the incorporation of Section 1109 to Chapter 9 proceedings, parties in interest have a right to appear and be heard on any issue in the Chapter 9 case; thus, they are entitled to object to confirmation. Such parties may include, among others, creditors whose claims are affected by the plan, the U.S. Securities Exchange Commission and specifically, under the express provision of Section 943(a), special tax payers (as defined in Chapter 9).

Incorporating the provisions of Section 1144, at any time within 180 days after entry of the confirmation order, the court in a Chapter 9 case may revoke the confirmation order if it finds, after notice and a hearing, that the order was procured by fraud.

## J. Effect of Confirmation and Discharge

Confirmation of a plan binds the debtor and any creditor whether or not (i) the creditor has filed (or is deemed to have filed) a proof of claim, (ii) such claim is allowed, or (iii) such creditor has accepted the plan. 11 U.S.C. § 944(a).

A Chapter 9 debtor receives a discharge after:

- (i) confirmation of a plan;
- (ii) deposit by the debtor of consideration under the plan with a disbursing agent; and
- (iii) determination by the Court that any securities deposited with the disbursing agent will constitute valid legal obligations of the debtor and that any provision made to pay or secure payment of such obligations is valid.

11 U.S.C. § 944(b). Under Section 944(c), the two exceptions to discharge are for (i) any debt excepted from discharge in the plan or confirmation order and (ii) any debt owed to an entity that, before confirmation of the plan, had neither notice nor actual knowledge of the case.

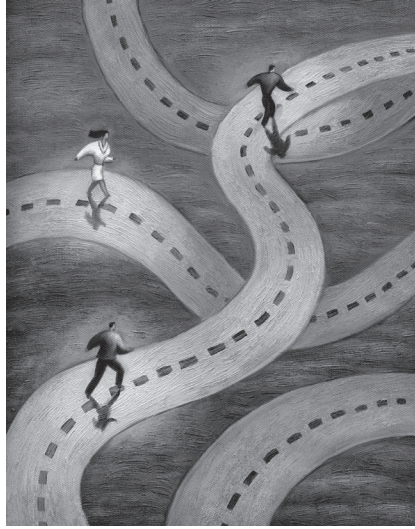
## K. Conclusion of a Chapter 9 Case

Pursuant to Section 945(a), the court may retain jurisdiction over a Chapter 9 case for as long as is necessary for a debtor to successfully implement the plan. Furthermore, pursuant to Section 945(b), except as provided in Section 945(a), the court shall close the case when administration of the case has been completed.<sup>121</sup>

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<sup>121</sup> Pursuant to Section 901(a), Section 350(b) of the Bankruptcy Code, which permits the reopening of a bankruptcy case for certain purposes, is applicable in Chapter 9 cases.





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