

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

Issues and Information for the Insolvency Professional

Chapter 11 - “101”



What Every Unsecured Creditor Should Know About Chapter 11

Contributing Editors:

Prof. John D. Ayer

University of California at Davis; Chico, Calif.
jdayer@ucdavis.edu

Michael L. Bernstein

Arnold & Porter LLP; Washington, D.C.
michael_bernstein@aporter.com

Jonathan Friedland

Kirkland & Ellis LLP; Chicago
jonathan_friedland@chicago.kirkland.com

Also Written by:

Ryan Blaine Bennett

Kirkland & Ellis LLP; Chicago
rbennett@kirkland.com

Editors' Note: This month, we address issues of concern to unsecured creditors of a chapter 11 debtor. By paying attention to the issues discussed below, an unsecured creditor can guard against unnecessary pitfalls, assert and effectively monitor its claim and maximize the amount of its recovery.

Creditors in a bankruptcy case and the priority of payment for their claims are distinguished by the type of claims they hold. The Bankruptcy Code sets forth a priority scheme for creditors' claims in §507. In general, creditors whose claims are secured by assets of the estate (a.k.a. secured creditors) are in a superior position (and such claims are outside the gambit of §507 entirely). Should a chapter 11 debtor fail in its attempt to reorganize, a secured creditor may generally look to the liquidation of its collateral for payment of its

claim (subject to many caveats, which we won't discuss here).¹

The Role of the Unsecured Creditor in Chapter 11

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

Steps to Take Immediately Upon Notice of a Chapter 11 Filing

First-day Hearings Can Impact Rights. Upon the filing of a debtor's bankruptcy case, the bankruptcy court will typically hear a series of motions filed by the debtor in which the debtor requests certain authority that it is not automatically entitled to receive under the Bankruptcy Code. In almost all cases, some of these motions include requests to treat certain creditors' claims differently than they might otherwise be treated by the Bankruptcy Code's priority scheme.

Specifically, these “first-day” motions often include requests for authority to immediately pay some or all of certain types of unsecured claims in advance of other unsecured claims. These include, *inter alia*, motions to pay pre-petition wages and benefits, critical vendor claims,² sales and

use taxes, customer obligations and other obligations depending on the nature of the debtor's business. In most cases, the bankruptcy court will grant these motions where it is shown that the payment of such claims is critical to maintaining the debtor's ongoing operations and going-concern value.

Also usually included among the first-day motions is the debtor's request to use cash collateral and/or obtain debtor-in-possession (DIP) financing. Once approved, such financing orders have a huge impact on the priority scheme for recovery in the bankruptcy case, as they usually involve priming and replacement liens, intricate debt service requirements and carve-outs for specific types of claims.³

Unsecured creditors and/or their advisors should read these motions to consider the potential impact on their rights. If appropriate, they should file an objection (or if there isn't enough time to file something, show up at the hearing and object). If you don't protect your rights, you may find that the game is half over just after it starts.

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

Another good source of information is the Office of the U.S. Trustee (UST). In almost all cases, the UST is briefed by the debtor in advance of the bankruptcy filing as

¹ See, generally, Ayer, J., Bernstein, M. and Friedland, J., “What Every Secured Creditor (and Its Lawyer) Should Know About Chapter 11,” ABI J. (Nov. 2003) (surveying a series of issues related to protecting a secured creditor's rights in bankruptcy).

² Depending on the applicable jurisdiction and the particular product/service sold by the creditor, a critical-vendor order can elevate mere general unsecured claims to a significantly higher priority, sometimes resulting in the full and immediate payment of the creditor's entire pre-petition claim.

³ In the near future, this column will feature a more in-depth discussion of chapter 11 financing.

to the debtor's first-day motions and general intentions for the restructuring. As the "watchdog" for the debtor's creditors, the UST is often helpful in providing information to creditors that might otherwise be difficult to decipher from the case documents themselves. This is important because, in most cases, many of the first-day motions will have already been heard before you've been able to serve out your Rule 2002 request.

In addition, not long after the case begins there will be an opportunity to meet with an attorney for the UST at the initial and/or §341 meetings of creditors. At each of these meetings, the UST will provide general details regarding the chapter 11 process and the particular case, and invite your questions. Debtor's counsel will also be on hand at these meetings to provide a case status summary and answer questions as well, and a representative of the debtor will appear and testify under oath.

Finally, the debtor is required to make certain and periodic filings as to its financial status, both as of the petition date and throughout the bankruptcy case. Among these are the debtor's schedule of assets and liabilities and statement of financial affairs. These filings can provide an initial indication of the debtor's position regarding a particular creditor's claim(s)—the amount the debtor thinks it owes, whether it disputes the claim, etc. They will also list the debtor's assets, secured and unsecured debts, contracts the debtor is party to, and much additional information. As with general pleadings, these documents can usually be found on the bankruptcy court's web site and/or obtained from the debtor's notice and claims agent. As an additional source of information, the debtor is also required to file monthly operating reports (MORs), each of which reflects the debtor's financial position and cash distributions made during the applicable monthly period.

Serving on the Committee Carries Its Burdens and Its Rewards. Shortly after the filing of a chapter 11 case, the UST will hold a meeting (at least in larger cases) to form an official committee of unsecured creditors, and will usually select candidates from the list of the 20 largest unsecured creditors filed by the debtor at the outset of the case. Once selected, the committee can engage legal counsel and financial advisors to assist it in carrying out its duties. Because the fees for these professionals are paid by the chapter 11 debtor's estate, membership on the unsecured creditors' committee is probably the most cost-effective way for individual unsecured creditors to influence the outcome of a bankruptcy case and protect their interests. The committee has standing to be

heard on any issue in the bankruptcy case, and its views tend to be taken seriously by the court.

Of course, along with the benefits of membership, there is some measure of burden. The committee is charged with monitoring and scrutinizing the debtor's chapter 11 process from start to finish. These obligations often involve numerous meetings, conference calls and negotiations. This process can be very time-consuming, particularly where the case drags on for months or years. Moreover, committee members owe fiduciary duties to all unsecured creditors, not just those creditors with similarly situated interests. This responsibility can be particularly vexing when a committee member is required to balance his own self-interests with the competing interests of other creditors. A committee member may also be restricted in trading in the debtor's securities. Consequently, like any other financial decision, the decision to serve on the committee should be carefully considered and eventually determined by weighing both the costs and the benefits.

Understand Reclamation Rights. As within the non-bankruptcy context, reclamation refers to the right of the seller to reclaim goods sold to a debtor while the debtor was insolvent. Section 546(c) focuses on that right in the context of a sale that took place immediately before the debtor filed for bankruptcy. In such cases, timing is a critical factor. There is a narrow window within which the seller must act to protect its rights. Specifically, the seller must make a written reclamation demand:

1. within 10 days of receipt of the goods by the debtor, or
2. if the 10-day period expires after the commencement of the bankruptcy case, within 20 days after the debtor received the goods.

In many large chapter 11 cases, even when a seller makes a timely and proper reclamation demand, the bankruptcy court will often grant the seller a priority claim instead of ordering a return of the goods. Such an order is a compromise between the reclaiming seller's rights under non-bankruptcy law (§2-702 of the UCC) to claim its goods and the debtor's interests in maintaining its going-concern value by not disrupting its supply chain. Some large commercial debtors will seek to streamline this process by filing a "reclamation procedures motion," requesting that this claim-substitution process occur automatically without the need to make individual requests for each reclamation claim.

Protecting/Collecting Your Claim

Proof of Claims and Bar Dates. Of all deadlines in a bankruptcy case, the proof-of-claim bar date is probably the most critical from a creditor's perspective. Missing a bar date is a serious matter. A late claim may be allowed if the creditor can show "excusable neglect," but no creditor—and especially no lawyer—wants to be in that position.

At some point in the bankruptcy case, the bankruptcy court will enter an order setting the bar date. Shortly thereafter, the debtor is required to send notice of the claims bar date to all known creditors. Attached to the bar date notice will be a sample proof-of-claim form that can be used for filing your proof of claim. A copy of the general form is also available at www.uscourts.gov/bkforms/official/b10.pdf.

Given the uncertainty of the postal service, it is not a good idea to just sit back and wait for a bar date notice to arrive. Once you are aware of the bankruptcy case, you should monitor the case docket to identify the bar date for your claim(s). Although the debtor is required to serve all known creditors with actual notice, if the debtor can show that the notice was mailed to any of your business addresses, for example, you'll face a steep burden to prove that such notice was never actually received. It's best to avoid this argument altogether and simply seek out the bar date of your particular case on your own without waiting for the notice to arrive.

In chapter 11 cases, you do not need to file a proof of claim if you agree with the way the debtor listed your claim in its schedules and your claim is not listed as contingent, unliquidated or disputed. However, it is usually a good idea to file a proof of claim in any event, even if your claim is included in the debtor's schedule of unpaid debts. The proof of claim does not need to reflect a liquidated amount in order to be timely filed. The debt can be contingent upon an event to occur in the future and, upon such occurrence, the proof of claim can be amended after the bar date to reflect the liquidated, non-contingent amount due. Unlike requests to file a late proof of claim, amendments to timely filed proofs of claim are freely granted and seldom opposed on timeliness grounds.

Monitoring the Debtors' Chapter 11 Plan and Proposed Distribution Timeline. For most unsecured creditors, payday will come after the chapter 11 debtor's plan is submitted and approved by the bankruptcy court. Timing for this process varies significantly from case to case, with some debtors filing plans on the first day of the bankruptcy and others not filing until

to receive it. The circumstances vary from case to case; the applicable provisions, if ultimately confirmed, have generally been vetted by the committee (and sometimes the UST) with the interests of the general unsecured creditors in mind. If you don't want to wait until confirmation to get paid, you may be able to sell your unsecured claim to a "claim trader." This is a valuable source of liquidity for creditors that are willing to take a discount in exchange for early recovery.

Preventive Maintenance

Counseling creditor clients *before* a bankruptcy can be a good way to win friends. As the old adage goes: "an ounce of prevention is worth a pound of cure." This saying is quite appropriate in the bankruptcy context, where proper preventive steps, if taken pre-petition, can significantly reduce a particular creditor's exposure and improve its standing in a bankruptcy case.

Avoiding Preference Liability. Many creditors don't realize it, but in addition to being left on the hook for their unpaid pre-petition claims, they may also be liable to the debtor's estate for receiving pre-petition preferential payments (a.k.a. preferences). Essentially, the Bankruptcy Code permits a debtor to sue creditors to recover payments made by the debtor shortly before the bankruptcy filing where the payment gave the creditor more than other similarly situated creditors would get through the bankruptcy process.⁴

The creditor/defendant, however, is not without defenses to these actions. For example, payments will be safe from recovery if they constitute contemporaneous exchanges, payments made in the ordinary course of business, and/or security interests that secure debts that bring new value to the debtor. By keeping accounts current and following ordinary billing practices, you can limit your exposure. Do not allow accounts to slip beyond customary payment terms.

Monitor the Debtor's Solvency. A number of financial services firms provide credit opinions regarding commercial companies and their ability to meet their debts as they become due. If, for instance, your company extends trade credit to a particular customer whose business represents a significant source of your company's revenue, it would be prudent to request such an opinion from time to time in order to hedge against the injuries you might incur should that customer file for bankruptcy.

Establish Protective Payment Alternatives. As mentioned briefly above, if you become aware that a particular company is a credit risk and may potentially seek

bankruptcy protection, you can significantly reduce your exposure by initiating certain payment alternatives that will protect your interests in the event of a filing. These alternatives include obtaining advance payment or cash on delivery (COD) for shipments, establishing an evergreen retainer or cash deposit, obtaining letters of credit and entering into third-party guarantees. ■

Reprinted with permission from the ABI Journal, Vol. XXIII, No. 5, June 2004.

The American Bankruptcy Institute is a multi-disciplinary, non-partisan organization devoted to bankruptcy issues. ABI has more than 10,000 members, representing all facets of the insolvency field. For more information, visit ABI World at www.abiworld.org.