NOTICE OF BANKRUPTCY: WHAT'S A COUNTY TO DO?

NORTH CAROLINA ASSOCIATION OF COUNTY ATTORNEYS
2021 WINTER CONFERENCE

VIDEOCONFERENCE

FEBRUARY 5, 2021

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County Attorneys are required to have knowledge in so many areas. The areas of frequent involvement do not present the challenges that less familiar areas may bring. One of those less familiar area may involve a portion of the United States Code known as the United States Bankruptcy Code ("Code" or "Bankruptcy Code"). The purpose of this manuscript is to provide an overview of bankruptcy and to provide focus and guidance on issues of concern to local governments in the bankruptcy process. All section references herein are to the Bankruptcy Code unless otherwise noted.

I. INTRODUCTION TO BANKRUPTCY.

It is important for county governments to have a working knowledge of the concepts of the Bankruptcy Code so that they can understand their relationship with the debtor going forward and can protect their rights when a customer or constituent files for bankruptcy. The concepts of bankruptcy in general are to provide a fresh start for debtors and to insure fair and equal treatment of creditors.

A. Fresh Start.

Bankruptcy's goal is to give the debtor an opportunity to have his obligations discharged so that he can make a "fresh start" in his financial life. Almost all debts, both secured and unsecured, can be discharged, although the collateral will generally remain subject to the lien. The only debts which are not dischargeable in any of the bankruptcy chapters discussed in this manuscript are spouse or child support, withholding taxes, taxes which the debtor willfully attempted to evade and certain other taxes. For individual debtors, the discharge is real and means simply that the debtor is completely discharged from all liability for debts which arose prior to the filing of the bankruptcy petition, except as noted above. Further, and equally important, the debtor is relieved from the demoralizing attempts of the creditors to collect the obligation. The goal of discharge is to restore to

the individual debtors an incentive to be productive, since the debtor will know that all future earnings are his and need not be applied to prepetition obligations.

The Chapter 11 debtor also receives the benefit of the fresh start in that there is protection from harassment based on prepetition obligations during the pendency of the Chapter 11 case and the Chapter 11 debtor receives — in effect — a discharge from prior obligations through the confirmation of the plan of reorganization. The terms of the plan specify what obligations will be paid to whom, in what amount and these plan obligations become the replacement obligations of the debtor from confirmation forward.

It is sometimes said that a bankruptcy discharge is available only to "honest debtors." It is true that debtors who commit certain kinds of dishonest acts, such as perjury or concealment of property from the bankruptcy court, can be denied a discharge in Chapter 7 proceedings. But that same debtor will probably be eligible for discharge in proceedings under Chapter 11 or Chapter 13 of the Code. Further, a Chapter 7 debtor who has obtained loans under false pretenses or obtained property through larceny or embezzlement will still be entitled to his general discharge, so long as he acts in good faith within the context of his bankruptcy. The court, however, can see to it that the particular debt which arose through fraudulent acts of the Chapter 7 debtor is not discharged. The creditor who was the debtor's victim may bring an action to have that particular debt determined to be non-dischargeable, even though the debtor receives a discharge of his other obligations.

B. **Fair and Equal Treatment of Creditors.**

It is not at all uncommon for creditors who are closely monitoring the status of their debtor to bring pressure to bear when they perceive that the debtor is faltering or when the debtor is behind in payment of that creditor's obligation. Creditors turn into the proverbial "squeaky wheels," trying to make sure that they get paid from the limited funds available before other creditors. This behavior often depletes the debtor's

operating funds and precipitates the bankruptcy filing. Other creditors attempt to secure liens on the debtor's assets in order to insure that they will have a priority position in any liquidation of the debtor's assets. Unencumbered assets often provide needed collateral for a critically needed loan; therefore, the creditor's fate may be sealed by the insistence on the grant of a security interest. Frustrated creditors may also bring lawsuits against the debtor, which become quickly known among the creditor body and which pose a significant barrier when the debtor looks for new funding or seeks to have goods or services provided on regular terms. While none of these acts by creditors is illegal, all can help to accelerate the debtor's decline and push them inextricably towards the bankruptcy filing. Those creditors who have cooperated with the debtor and given extended terms or been willing to continue to provide goods and services on a credit basis, have contributed to the debtor and ought not be penalized; therefore, the Bankruptcy Code seeks to "equalize" the treatment of the various creditors by reversing any preferential treatment which occurred during the period immediately prior to the bankruptcy filing. Creditors who received payments or liens within the 90-day period or, if the recipient is an "insider" of the debtor, payments or liens within a two-year period, before the bankruptcy filing may be forced to disgorge such payments or have their liens voided. The fair and equal treatment concept continues into the distribution phase of the bankruptcy since creditors who are equally situated are treated equally and receive pro rata distributions. Chapter 11 also has specific provisions to cause similarly situated creditors to be treated fairly and equally.

II. OVERVIEW OF BANKRUPTCY RELIEF BY CHAPTERS

A. Chapter 7 — Liquidation.

1. Eligibility for Relief.

Chapter 7 of the Code provides for liquidation of a debtor's estate and is commonly referred to as "straight bankruptcy." Any person--the term "person"

includes individuals and business entities--may be a debtor under Chapter 7 if such person is not "a railroad, bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, credit union or industrial bank." A person need not be insolvent to be eligible for Chapter 7 relief. In fact, Chapter 7 debtors are not even required to have substantial debts or a minimum amount of obligations. Unless a Chapter 7 proceeding is being initiated by an involuntary petition, there is no requirement that the debtor be unable to pay his debts as they become due; however, Chapter 7 has requirements for eligibility and forces more individual debtors into Chapter 13.

2. **Types of Chapter 7 Cases**.

Cases come into Chapter 7 by three different routes:

a. **Voluntary Cases**. The vast majority are filed "voluntarily" by debtors who own no substantial non-exempt assets and whose main purpose is to obtain relief from their debt. Because debtors control the timing of these filings, it often happens that debtors have liquidated large portions of their estates informally prior to the filing by granting liens to preferred creditors, returning unneeded items of collateral to creditors holding liens and converting other assets into exempt property. It will be the trustee's responsibility to investigate whether these prepetition transfers are recoverable or whether the case is essentially a "no-asset case" where there are insufficient assets to cover administrative costs, leaving no funds to be distributed to unsecured creditors.

b. **Involuntary Cases**. The second route involves the filing of an "involuntary" petition by the debtor's creditors. This happens most often when the creditors believe that the debtor has made a substantial

preferential transfer to another creditor or to an insider of the debtor. Generally, the purpose of involuntary filings is to enable the trustee to recover the property transferred and to redistribute it pro rata among all the creditors. Involuntary cases are more likely to involve substantial unencumbered non-exempt assets because the debtor does not control the timing of the filing and may not have been able to "plan the estate" in advance.

c. **Conversion to Chapter 7**. The third route for Chapter 7 filings is by way of conversion of the case from Chapters 11, 12, or 13 to Chapter 7. Conversion is most likely to occur in a Chapter 11 when it becomes clear to the debtor that the business continues to flounder and when the creditors of the estate voice their concerns that the debtor is causing the value of the estate to decline while using funds in a hopeless attempt to reorganize. Conversions following Chapter 13 cases generally occur when the debtor is unable to make the payments under the Chapter 13 plan and decides that the better route is to obtain a discharge of all remaining debts.

3. **How Chapter 7 Works**. The Chapter 7 debtor commits all of its assets to the bankruptcy estate and then files a list of exemptions stating which items of property are to be "exempted" from the estate. North Carolina Gen. Stat. § IC-1601(a) statutes set out the main exemptions in North Carolina.

The property which is not exempted from the estate is liquidated by the trustee. Secured creditors receive their collateral or the value of their collateral. The trustee also makes whatever recoveries he can for the estate (*i.e.*, recovery of preferential transfers, collection of debts owed to the debtor). Funds thus collected are ultimately distributed to the creditors holding allowed claims.

The trustee examines the debtor's exemptions and the trustee or any creditor may object to the list of property claimed as exempt within 30 days after the conclusion of the first meeting of creditors. If no objection is filed, the exemptions are allowed as filed. Individuals can obtain a discharge in a Chapter 7 liquidation. There is an opportunity to object to discharge by the trustee or any creditor of the debtor. If no objections to discharge are filed, upon expiration of the discharge objection period, the bankruptcy court will enter an Order of Discharge without further hearing. Under Section 523, there are exceptions to discharge including for property taxes incurred before the case and payable one year before the petition was filed as well as certain income and excise taxes.

B. **Chapter 9 – Adjustment of Debts of a Municipality.**

Municipalities can also file bankruptcy pursuant to Chapter 9 of the Bankruptcy Code. Chapter 9 does not limit or impair the right of a State to control, by legislation or otherwise, a municipality of such State in the exercise of the police and local powers for such municipality, with limited exceptions. In addition, bankruptcy court cannot, unless the debtor municipality consents or the Chapter 9 plan provides, interfere with governmental powers of the municipal debtor or any of its property or revenue. Chapter 9 makes specific reference to the sections of the Bankruptcy Code applicable to it. In a Chapter 9, a plan is proposed by the debtor to handle its debts and reorganize and the court can confirm a plan of reorganization.

C. **Chapter 11 - Reorganization.**

1. **"Standard" Chapter 11**. A person who qualifies as a debtor under Chapter 7 (and is not a stockbroker, commodity broker or railroad) may be a Chapter 11 debtor. Congress has established broad eligibility requirements for Chapter 11 relief which makes it readily available to most debtors. However, on a practical side, if there is little or no likelihood of rehabilitation, there is little point in

delaying the inevitable conversion to Chapter 7. Chapter 11 can be an expensive process and it always creates administrative expenses which must be paid out of estate assets to the detriment of unsecured creditors. Occasionally, Chapter 11 cases are filed when it is known ahead of time that there will be no true reorganization, but rather a "liquidating Chapter 11." This scenario occurs when it is believed that the best value for the debtor's assets will be realized from sale as a "going concern" in a Chapter 11 rather than a Chapter 7.

2. **Subchapter V**. The Small Business Reorganization Act of 2019 ("SBRA"), signed by President Trump on August 23, 2019, enacted a new Subchapter V of Chapter 11, codified as new 11 U.S.C. §§ 1181 – 1195, and made conforming amendments to several sections of the Bankruptcy Code and statutes dealing with appointment and compensation of trustees in Title 28. SBRA also revised the definitions of "small business case" and "small business debtor" in § 101(51C) and § 101(51D), respectively. It took effect on February 19, 2020, 180 days after its enactment. A debtor was ineligible to be small business debtor if its debts (with some exceptions) exceeded $ 2,725,625; however, the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"), enacted and effective March 27, 2020, amended the SBRA to increase the debt limit to $ 7.5 million for purposes of Subchapter V for one year and made certain technical corrections.

According to the legislative history, the purpose of SBRA is "to streamline the process by which small business debtors reorganize and rehabilitate their financial affairs." The idea was to allow small business debtors "to file bankruptcy in a timely, cost-effective manner, and hopefully allows them to remain in business," which "not only benefits the owners, but employees,

suppliers, customers, and others who rely on that business."[1] For electing small business debtors, Subchapter V: (1) modifies confirmation requirements; (2) provides for the participation of a trustee while the debtor remains in possession of assets and operates the business as a debtor in possession; (3) changes several administrative and procedural rules; and (4) alters the rules for the debtor's discharge and the definition of property of the estate with regard to property an individual debtor acquires post-petition and post-petition earnings (which has implications for operation of the automatic stay of § 362(a)). Much of how a confirmed Subchapter V case progresses depends upon if the plan is confirmed by consent or not. Only the Subchapter V debtor may file a plan or a modification of it. Subchapter V has other technical differences from the "standard" Chapter 11, but those details are beyond the scope of this presentation.

D. **Chapter 12 - Adjustment Of Debts Of A Family Farmer.**

Only a family farmer or fisherman with regular income can be a debtor under Chapter 12. The Code permits either an individual (or married couple) or a corporation or partnership to be a family farmer for the purposes of Chapter 12. A Chapter 12 trustee is appointed to supervise the administration of the Chapter 12 case; however, the debtor continues to operate the business. A plan is filed by the debtor with the bankruptcy court providing for payments to creditors and reorganization of debts. The debtor is entitled to a full discharge at the time the debtor has completed all Chapter 12 payments with certain exceptions.

[1] H.R. REP. NO. 116-171, at 4 (statement of Rep. Ben Cline). The court in *In re Progressive Solutions, Inc*, 2020 WL 975464, at *1-3 (Bankr. C.D. Cal. 2020), reviewed the legislative progress of SBRA and included public statements from several cosponsors of the law, including Senators Charles Grassley, Sheldon Whitehouse, Amy Klobuchar, Joni Ernst, and Richard Blumenthal.

E. **Chapter 13 - Adjustment of Debts for Individuals.**

1. **Eligibility for Relief**.

Only individuals with regular income, or an individual with regular income and that individual's spouse, may file for relief under Chapter 13. Debt ceilings are established for potential Chapter 13 debtors. Debtors have to certify to the bankruptcy court that they have obtained credit counseling prior to filing of the petition.

Small sole proprietors as well as regular wage earners are permitted to file under Chapter 13. Corporations, partnerships, stock brokers and commodity brokers are not eligible for Chapter 13. Chapter 13 is a purely voluntary proceeding and only the debtor can place himself in Chapter 13. A "means" test determines if a debtor exceeds certain financial thresholds, the debtor is required to file a Chapter 13 instead of a Chapter 7.

2. **Requirement for Regular Income**.

The Chapter 13 requirement for regular income means that the debtor must have income which is sufficiently stable and regular to enable him or her to make payments under a Chapter 13 plan. There must be enough anticipated income over projected monthly expenses to provide for payments to creditors in order for the debtor to be deemed an individual with regular income. The income need not come from the debtor's employment. Social security, disability, alimony or other regular sources of income will qualify a debtor for Chapter 13.

3. **How Chapter 13 Works**.

In a Chapter 13 proceeding, the debtor proposes a plan for the repayment of all or a portion of his or her debts over a period of not less than three years and no more than five years. The Code also sets out certain particulars regarding the plan and if the plan meets those requirements, the court must confirm it, whether

or not the creditors approve of it. Upon confirmation of the plan, it becomes binding upon the creditors, including those who objected to it. During the years of the Chapter 13 plan, the debtor is making payments under the plan from his regular post-filing income to the Chapter 13 trustee for distribution pursuant to the plan to the creditors, unless the Chapter 13 plan provides for direct payments to a creditor and the debtor is permitted to retain all of his or her property, including property which is not exempt. After the debtor completes the payments specified in the plan, the portion of debts still owing are discharged, except for alimony, child support and certain long-term debts (such as a mortgage on the debtor's home which the debtor has elected to pay in order to retain the home).

III. THE PLAYERS.

A. Debtor or Debtor in Possession (DIP).

The individual or business entity which has filed bankruptcy is known as the debtor. In a Chapter 11 case, the debtor is referred to as a debtor-in-possession or "DIP" since the debtor is continuing "in possession" of the business. A DIP operates the business during the Chapter 11 case and has generally the same rights, duties and powers as a trustee. If a trustee is appointed in the Chapter 11 case and is given "operating" authority then there is no DIP.

B. Trustee.

1. Chapter 7 Trustees.

a. **Appointment**. Shortly after a case is filed under or converted to Chapter 7, the bankruptcy court appoints an "interim trustee" from the panel of private trustees. In most districts, the interim trustee will be an attorney who is regularly engaged in bankruptcy practice although this is not a requirement. While creditors of the Chapter 7 debtor have the

opportunity to elect a trustee of their own choosing, they seldom do so. The interim trustee ordinarily serves throughout the entire case.

b. **Duties**. One of the trustee's duties is to collect and liquidate the property of the estate. The Code provides that the trustee "is the representative of the estate." The duties of the trustee as set out in the Code are to:

- collect and reduce to money the property of the estate;
- be accountable for all property received;
- ensure that the debtor performs his duties;
- investigate the financial affairs of the debtor;
- examine proofs of claim and object to the allowance of any claim that is improper;
- oppose the discharge of the debtor in appropriate circumstances;
- furnish information concerning the estate and the estate's administration as requested by parties in interest;
- if the debtor's business is being operated, file with the bankruptcy court and appropriate parties, periodic reports and summaries of the operation of the business; and
- make a final report and file a final account of the administration of the estate.

2. **Chapter 11 Trustees.**

a. **Trustee Only Appointed in Special Circumstances.**

In the normal situation, the DIP performs the functions of a trustee. However, a trustee may be appointed in a Chapter 11 case at the request of a party in interest and after notice and hearing. A Chapter 11 trustee may be appointed in a case where "cause" exists, including fraud,

dishonesty, incompetence or gross mismanagement of the affairs of the debtor, either before or after the petition was filed; or when such appointment is "in the interest of creditors, equity security holders and the estate." As discussed earlier, a Subchapter V trustee is appointed in ever Subchapter V case. Those duties are far more limited than those below but can be expanded by the court.

b. **Duties**.

The duties of a Chapter 11 trustee include the duty to:

- be accountable for all property received;
- examine proofs of claim and object to the allowance of any improper claim;
- furnish information concerning the estate and the estate's administration to parties in interest who request such information;
- file periodic reports and summaries of the operation of the business with the Court;
- make a final report and file a final accounting of the administration of the estate;
- file the lists, schedules and statement of financial affairs (if the debtor has not already done so);
- investigate 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 the plan;
- file a statement of any investigation conducted in the estate including any facts learned pertaining to fraud, dishonesty, incompetence,

misconduct, mismanagement, or irregularity in the management of the affairs of the debtor or regarding a cause of action available to the estate;

- file a plan of reorganization or a report explaining why a plan is not appropriate or recommending conversion of the case to Chapter 7, 12 or 13;
- file tax returns for the debtor; and
- file post-confirmation reports as appropriate;

3. **Chapter 12 Trustees.**

a. **Appointment**.

Each judicial district generally has one or more Chapter 12 Standing Trustees who are appointed by the U. S. Trustee except in North Carolina and Alabama, where they are appointed by the bankruptcy court.

b. **Duties**.

The Chapter 12 trustee supervises the administration of the Chapter 12 case, but each Chapter 12 debtor continues in possession of the property of his estate and continues to operate the farm in much the same way as a Chapter 11 DIP operates the business. The Chapter 12 trustee has all the duties of a trustee in a Chapter 7 case except that the Chapter 12 trustee does not collect or liquidate the property of the estate, has no duty to investigate the financial affairs of the debtor, and is not required to file periodic reports. On request of a party in interest, the court may order the trustee to investigate matters pertaining to the farmer's business and the desirability of its continuance and require the trustee to file a statement of the investigation.

Where fraud, dishonesty, incompetence or gross mismanagement may be shown, a creditor or the trustee may request that the debtor be removed from possession of the property of the estate and the trustee placed solely in control. In such a case, though the trustee may be placed in charge of operating the debtor's farm, the trustee does not have the power to file a Chapter 12 plan. That right is reserved exclusively to the debtor.

4. **Chapter 13 Trustees.**

a. **Appointment**.

Each judicial district generally has one or more standing Chapter 13 trustees appointed by the U. S. Trustee or, in North Carolina and Alabama, by the bankruptcy court.

b. **Duties**.

The duties of the Chapter 13 trustee are the same as the Chapter 7 trustee except that the Chapter 13 trustee does not collect the assets of the estate and reduce them to money or file tax reports. Additionally, if the Chapter 13 debtor is engaged in business, the Chapter 13 trustee is charged with the same investigatory and reporting functions as a Chapter 11 trustee. Practically speaking, this investigation rarely occurs unless a creditor calls a matter to the Chapter 13 trustee's attention and demands investigation due to the sheer volume of Chapter 13 cases a Chapter 13 trustee handles. The Chapter 13 trustee is to appear and be heard at any hearing that concerns the value of property subject to a lien, the confirmation of a plan or the modification of the plan after confirmation. The Chapter 13 trustee should advise the debtor and assists him or her in performance of the plan. The best Chapter 13 trustees contribute to the rehabilitation of the debtor, often by providing educational programs to

assist Chapter 13 debtors in achieving better management of finances. The trustee receives the debtor's plan payments and distributes those payments in accordance with the Chapter 13 plan to the various creditors.

C. **United States Bankruptcy Administrator.**

North Carolina has a Bankruptcy Administrator for each district who is charged with functions similar to a U.S. Trustee in that the Bankruptcy Administrator oversees the panel of trustees who serve in Chapter 7, 12 and 13 cases and supervises the administration of cases in the Bankruptcy Administrator's district.

D. **Examiner.**

An examiner investigates the acts and business affairs of a Chapter 11 debtor. An examiner may be appointed by the Court without changing the status of a debtor-in-possession. The Code allows examiners to be appointed on request of a party in interest in following notice and hearing. Examiners are appointed for specific purposes including conducting investigations into alleged fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management affairs of the debtor by current or past management.

E. **Creditor's Committee (Chapter 11).**

1. **Appointment.**

While a creditor's committee can be formed in a Chapter 11 or a Chapter 7, they are extremely rare in the Chapter 7 context. Under Chapter 11, the Code mandates the appointment of a committee of creditors (non-insiders) holding unsecured claims and allows the appointment of any additional committees of creditors or equity security holders which are deemed appropriate. Committees are generally appointed by the U.S. Trustee, but in North Carolina they are appointed by the court on the recommendation of the Bankruptcy Administrator.

Ordinarily, the twenty largest unsecured creditors are offered the opportunity to serve on the unsecured creditors' committee. If no creditors accept this opportunity, no creditors' committee is formed. If a committee is formed in a case and if committee counsel has been appointed in the case, he or she is often a good source to contact if questions arise in a case.

2. **Powers and Duties.**

Creditors who accept membership on the creditor's committee undertake a fiduciary duty to the other creditors with similar (*i.e.*, unsecured) claims. An effective creditor's committee can be of great assistance to the debtor and provide great protection to the creditors. The committee is authorized to employ attorneys, accountants or other agents, following approval by the court. The specific powers and duties of the committee as set forth in the Code are to:

- Consult with the trustee or DIP concerning administration of the case.
- Investigate the acts, conduct, assets, liabilities and financial condition of the debtor, the operation of the debtor's business and the desirability of continuance of such business, and any other matter relevant to the case or to the formulation of the plan.
- Participate in the formulation of a plan, advise those represented by such committee of such committee's determination as to any plan formulated, and collect and file with the Court acceptances and rejections of a plan.
- Request the appointment of a trustee or examiner when appropriate.
- Perform such other services as are in the interest of those represented.

F. **Professionals.**

Trustees, debtors in possession, examiners, and committees appointed by the court, are entitled to retain legal counsel and other professionals whose reasonable fees and

expenses are generally taxed against the bankruptcy estate. Such counsel must be approved by the court after an application to employ, which contains complete disclosures regarding the professional sought to be employed and which demonstrates the absence of any conflict of interest between that professional and the estate. In addition to obtaining court approval to serve, counsel so hired must file applications for fees and expenses which are reviewed by the client, the U.S. Trustee or Bankruptcy Administrator, the court and the creditors. Only those fees and expenses applied for and approved by the court may be properly paid. Lenders and other individual creditors who employ professionals to represent them in the case do not have to obtain court approval for their counsel, even though, in certain circumstances, their fees and expenses may also be reimbursed from the estate. Professional fees and expenses, once awarded, are recorded as special "administrative priority" over the claims of unsecured creditors (*i.e.* these expenses get paid before any funds are distributed to unsecured creditors, therefore, usually reducing the amount of money the unsecured creditors will receive). Therefore, the court must carefully consider any request for employment of professionals and must scrutinize fee and expense applications. Other professionals who are frequently employed upon court approval are appraisers, auctioneers, expert witnesses for litigation, investment bankers and "turn-around or work-out" specialists.

G. **Creditors and Priority of Distribution in a Bankruptcy Case.**

Since equal treatment of creditors is a basic concept underlying the Code, equal treatment in the distribution of estate assets means a "pro-rata" distribution. That pro-rata distribution has been modified by statutory "niches" which control the priority of distribution. Distribution priorities are fixed by statute and the court has no discretion to vary the priorities, although the priorities can, however, be varied either by agreement of the affected creditors or by the court's subordination (subordination results in another class of claim getting paid before the subordinated class becomes eligible for payment) of

a particular claim or class of claims to remedy improper or inequitable conduct. The order of priorities in the Bankruptcy Code is as follows.

1. **Secured Creditors.**

To the extent a secured claim is perfected as required, the secured portion of the creditor's claim is satisfied in full before the bankruptcy priority system begins to operate. For example, if an asset is worth $200,000 and a secured claim exists for $120,000, then the secured creditor recovers the amount of the claim from the proceeds of the collateral and the remainder of the proceeds become available to the general creditor body. To the extent that a secured creditor is over-secured, the secured creditor will be entitled to principal, and both prepetition and post-petition interest accruals and late charges. An undersecured creditor is not entitled to a claim against the estate for post-petition interest accruals and late charges, or his attorneys' fees. Additionally, the oversecured creditors will be able to recover attorney's fees, costs, etc. in full from the proceeds of the collateral if his documents provide a right to these items.

In cases where the collateral will not be liquidated (*i.e.*, a Chapter 11 reorganization plan), it often becomes necessary to determine the value of the collateral so as to fix the portion of the claim which will be allowed as "secured" and the portion of the claim which will be allowed as "unsecured". In those situations where the value of the collateral is less than the amount of the debt, a creditor is only secured as to the assets upon which a security interest has been perfected (and cannot be avoided), and only up to the value of those assets.

2. **Expenses of Administration and Super Priorities.**

a. **Administrative Priority (§507(a)(1) and §503)**.

Administrative expenses receive the first priority since these expenses generally reflect the cost to administer the bankruptcy estate. Expenses of administration set out in the Code are as follows:

(1) Domestic support obligations;

(2) Actual, necessary costs and expenses of preserving the estate including wages, salaries or commissions for services rendered after the filing of the bankruptcy petition;

(3) Taxes incurred by the estate;

(4) Compensation and reimbursement of estate professionals; and

(5) Actual, necessary expenses incurred by creditors filing an involuntary petition or a creditor that recovers estate property.

b. **Super-Priority - (Section 364(c)(1))**.

Section 364(c)(1) allows the granting of a "super-priority" claim which will be paid before the ordinary expenses of administration. Super-priority claims arise where the trustee or DIP is unable to obtain unsecured credit by merely granting an administrative expense priority to the lender. In such a situation, after notice and hearing, the court may authorize the extension of post-petition credit and the lender's receipt of a super-priority claim. When a super-priority position is granted to a post-petition lender it is common to find a "carve-out" for attorneys' and other professionals' fees which means that the lender's super-priority claim is superior to all but the claims of the carved out professional fees.

3. **Other Priorities (Section 507(a)(2-8).**

After administrative expenses are paid, there are other items, including the following items, which are paid in full in a specified order of priority before any funds are made available for distribution to unsecured creditors:

a. **Involuntary Gap Claims**.

"Involuntary Gap" claims which can include taxes and which arise in the ordinary course of business or financial affairs between the time an involuntary petition for relief is filed and time the order for relief is entered by the Court (usually thirty to forty five days).

b. **Labor claims and employee benefit claims**.

This labor priority is based on the concept that the debtor's employees are a vulnerable group that they will need to be guaranteed receipt of the paycheck covering the period immediately prior to filing if they agree to continue to work for the debtor. This priority includes unsecured claims for wages, salaries or commissions, including vacation, severance and sick leave pay earned by an individual within 180 days before the filing and only to a maximum for each individual as set by the Code, currently $13,650.00 (adjusted regularly for inflation). To the extent the labor claim priority amount is not exhausted, the employees are eligible to a priority claim for employer contributions which should have been made to employee benefit plans.

c. **Grain Farmers and United States Fisherman**.

Claims by persons who produce grain for a debtor who owns or operates a grain storage facility and claims of a fisherman up to $6,725.00 (adjusted regularly for inflation) set by Code.

d. **Deposits for Personal, Family or Household Goods or Services**.

Unsecured claims arising from prepetition deposit of money in connection with purchase lease or rental of property or purchase of services for personal, family or household use when such goods or

services were not delivered or provided, up to a $3,025.00 (adjusted regularly for inflation) maximum as set by the Code.

e. **Tax Claims**.

Several and different types of taxes payable to federal, state and local taxing authorities as follows: (1) income taxes; (2) property taxes; (3) withholding or sales taxes; (4) employment taxes on wages, salary and commission; (5) excise taxes; (6) certain custom duties.

4. **Unsecured Creditors**.

These are the general unsecured creditors of the estate to whom money is owed for goods or services provided prepetition. All unsecured claimants generally received pro rata distributions. Occasionally, a plan of reorganization treats the smaller unsecured claims in a separate class for administrative convenience purposes and actually pays them a higher percentage of their unsecured claims than the other unsecured claims receive. When this occurs, the reorganizing debtor groups gather those unsecured claimants who have claims below a set amount — such as $1,000 — and agrees to pay those creditors in full on the effective date of the plan, thus eliminating a large number of claims in the estate. Usually, parties with larger claims can elect to be included in the administrative convenience class and accept the stated amount in full settlement of their claim.

5. **Interest holders.**

In this class are the claims of the partners or shareholders of the debtor. They receive a pro rata distribution of whatever is left over after all of the debtor's creditors have received their distributions. In the typical case, there is nothing left over for distribution for this class of creditors. Under a Chapter 11 plan of reorganization, interest holders often attempt to retain their equity interest in the event the debtor successfully reorganizes. As this action is really a distribution

under the plan, holders cannot keep their stock and equity interests over the objections of other creditors unless the holders fairly compensate the creditors for the retained interest. This "New Value" issue is still controversial in bankruptcy cases, but it is not an issue in Subchapter V cases.

IV. RULES/PROCEDURES

A. Commencement of the Case.

The debtor must pay a price for filing for relief under the Code. The debtor is expected to file a petition and other related documents which provide full disclosure of assets, liabilities and recent business and financial activities to creditors. The Bankruptcy Code, bankruptcy rules, and local bankruptcy rules provide a number of different means for obtaining information about the debtor's conduct and business. The diligent creditor will study these sources of information and take the necessary steps to assure that all possible assets are recovered for the estate and that creditors participate in distributions from the estate only to the extent that they are entitled to do so.

1. Petition For Relief.

A voluntary bankruptcy case is commenced by filing with the Clerk of the United States Bankruptcy Court a Petition for Relief under Chapter 7, 11, 12 or l3. Initiation of a bankruptcy case is governed by Section 301 of the Bankruptcy Code and Bankruptcy Rule 1002. The filing of a voluntary petition for relief with the Clerk of the Bankruptcy Court constitutes an Order for Relief under the Chapter for which relief has been sought.

The Petition for Relief should bear a caption with the name of the court, a blank for the court to insert the docket number of the case, chapter of the case, name of debtor(s), social security number for individual debtors or tax identification number for business debtors, and all names used by the debtor within six years

prior to filing the petition. The body of the Petition for Relief should contain the following statements:

a. Debtor's mailing address, including county;

b. Verification that the residence or domicile of the debtor, the debtor's principal place of business, or the location of the debtors' principal assets has been within the district for the 180 days preceding filing;

c. Qualification of the signing petitioner to file the petition for relief;

d. Statement of the Chapter under which relief is sought;

e. Signature of the attorney for the petitioner and the verified signature of the debtor or unsworn declaration of the debtor.

Local Rules of Court for the district where the petition is filed also may require additional information.

2. **List of Creditors.**

A petition must also be accompanied by a mailing list or matrix of all creditors and other parties in interest. The matrix must be prepared strictly according to the format provided by each district. A creditor who does not receive notice of the bankruptcy proceeding may have its debt exempted from discharge under Section 523(a)(3). A Chapter 11 petition must also be accompanied by a list of the debtor's twenty largest unsecured creditors who are non-insiders, including names, addresses and amounts owed. In large cases, debtors have filed a top 30 or 50 list of creditors. The committee of unsecured creditors will be appointed from this list of the largest unsecured creditors.

3. **Schedules of Assets & Liabilities and Statement of Financial Affairs.**

Unless given additional time by the court, the debtor must, within 14 days of the petition, file a detailed schedule of assets and liabilities, schedule of current income and expenditures, statement of financial affairs, statement of executory

contracts and unexpired leases, and list of equity holders. The list of equity holders may be impounded and only subject to inspection upon specified terms. The Statement of Financial Affairs gathers other financial information not captured by the schedules such as sources of income other than from employment or business, transfers of assets, lawsuits, foreclosures, losses, transfers to insiders, safe deposit box information, spouse information, environmental information and business information including shareholders, partners, directors, accountants and even inventory lists. The schedules are: Schedule A – Real Property; Schedule B – Personal Property; Schedule C – Property Claimed as Exempt; Schedule D – Creditors Holding Secured Claims; Schedule E – Creditors Holding Priority Unsecured Claims; Schedule F – Unsecured Non-Priority Creditors; Schedule G – Executory Contracts and Leases; Schedule H – Co-Debtors; Schedule I – Current Income of Individual Debtors; Schedule J – Current Expenditures of Individual Debtors.

4. **Notice of Commencement of Case.**

The clerk will issue a notice advising creditors of the filing of the bankruptcy case. The notice holds important initial information such as the deadlines for creditors and governmental units to file a proof of claim, the deadline to object to debtor's discharge or challenge dischargeability of a debt, the date for the 341 first meeting of creditors, a reminder of the automatic stay and other filing information on the case.

5. **Chapter 11 Operating Orders.**

In each district, the bankruptcy court usually issues an operating order for debtors-in-possession. This order may include instructions relating to the debtor's handling of books and records, bank accounts, collateralization of accounts, tax accounts and deposits, filing of tax returns, insurance, cash

collateral, monthly status reports, appointment of professionals, compensation of debtor's employees and disposition of assets.

B. **Procedure - Motions Versus Adversary Proceedings.**

1. **The Case**.

Most actions arising in the bankruptcy case are handled by motion--either a motion to take an act contemplated by the Bankruptcy Code (as in a motion to assume an executory contract) or by motion in a contested matter where parties disagree on activities regarding estate assets (as in a motion to lift the automatic stay). Whether regular business of the case or a contested matter, motions are generally handled by the filing of a written pleading accompanied by notice which is served on all affected parties and parties entitled to notice. A hearing is then held, the specific matter resolved and an order entered reflecting that resolution.

2. **Adversary Actions**.

Certain actions in the underlying bankruptcy case, however, must be brought in the form of an "adversary proceeding." An adversary proceeding looks much like a regular lawsuit, except that it is filed in the bankruptcy court and is subject to the Bankruptcy Code and bankruptcy rules. Bankruptcy Rule 7001 lists certain actions which must be handled via an adversary proceeding:

a. Recovery of money or property of the estate.

b. Determination of the validity, priority, or extent of a lien or other interest in property.

c. Solicitation of court approval for the sale of an estate asset where the estate has a co-owner in the property.

d. Objection to or revocation of discharge.

e. Revocation of an order of confirmation of a Chapter 11, Chapter 12 or Chapter 13 Plan.

f. Determination of the dischargeability of a debt.

g. Request for court issuance of an injunction or other equitable relief.

h. Subordination of any allowed claim or interest.

i. Request for court issuance of a declaratory judgment.

j. Determination of a claim or cause of action removed to bankruptcy court.

k. Preference recovery actions and fraudulent conveyance recovery actions.

Adversary proceedings are in essence litigation in the bankruptcy court. They are initiated by the filing of a complaint with the bankruptcy clerk and the issuance and service of a summons. Thereafter, the adversary proceeding proceeds similarly to a regular lawsuit with a period for answer by the defendant, entry of a pretrial order setting deadlines for motions, discovery, exchange of exhibits, and mandatory conferences, and thereafter a trial on the merits before the bankruptcy court. Service of the bankruptcy adversary summons and complaint is accomplished nationwide by mail. The answer period is 30 days from the date the summons is issued so parties served with complaints in bankruptcy adversary proceedings must attend closely to the answer period. At times, the court may order mediation in an adversary proceeding. As a practice reminder for governmental entities involved in a mediation, be sure whoever attends the mediation on the governmental entities' behalf, has the authority to make a settlement. Get Board of Commissioner approval for settlement before the mediation. If the person attending the mediation does not have authority to settle, then sanctions may be imposed. If settlement is made and not honored because Commissioner approval is needed, there could be a breach of contract action with significant damages. Finally, the bankruptcy court establishes a

separate file for each adversary proceeding filed in the base case. It is therefore necessary to have the number of the adversary action in order to locate and review the court file. All adversary proceedings filed in the base case are noted on the docket of the base case.

V. BANKRUPTCY CONCEPTS.

A. The Automatic Stay.

1. Creation and General Scope of the Automatic Stay.

The filing of a voluntary or involuntary bankruptcy petition gives immediate relief to the debtor by creating a broad injunction or stay. Willful violation of the stay may result in sanctions, including actual and punitive damages, costs and attorney's fees. The stay arises automatically under Section 362 of the Bankruptcy Code (no court order is required) and operates against:

a. **Prepetition Claims**.

Commencement or continuation of legal proceedings against the debtor that were commenced (or could have been commenced) prior to the petition to recover a claim against the debtor that arose prepetition.

b. **Prepetition Judgments**.

Enforcement of a prepetition judgment against the debtor or property of the estate.

c. **Property of The Estate**.

Any act to obtain property of the estate, to obtain property from the estate, or to exercise control over property of the estate.

d. **Liens**.

Any act to create, perfect, or enforce any lien against property of the estate or property of the debtor to the extent it secures a prepetition claim.

e. **Collection Efforts**.

Any act to collect, assess, or recover a claim against the debtor that arose prepetition.

f. **Setoffs**.

The setoff of any debt owing to the debtor prepetition against any claim against the debtor.

g. **Tax Court Proceedings**.

Commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

The Bankruptcy Code specifies a number of exceptions to the automatic stay where action can proceed against the debtor, including, but not limited to, criminal proceedings, certain governmental actions to enforce police or regulatory powers, and certain acts to perfect security interests granted prepetition where perfection relates back to the granting of the interest. Bankruptcy courts have held that where a governmental entity acts to enforce regulatory authority, such as protecting the health, safety or welfare of its public, its actions are exempt from the automatic stay. Unfortunately, there is no bright line rule to determine when the government is acting in its regulatory capacity versus in a creditor capacity. The automatic stay does not prevent creation of property tax liens for taxes, special taxes and assessments due after the bankruptcy is filed. Certain other exemptions from the automatic stay are applicable to city and county governments related to taxes and utilities as discussed later in this manuscript. Procedures are also provided for moving the Court to "lift" the stay, *i.e.*, to terminate, annul, modify, or condition the stay. Unless relief from stay is granted, the stay remains in effect until:

the assets it protects are no longer property of the estate; and

the case is either "closed" (after the reorganization plan is confirmed) or dismissed, or if the case is a case under Chapter 7 concerning an individual or a case under Chapter 11, 12 or 13, a discharge has been granted or denied.

2. **Relief from Stay.**

The protections afforded by the automatic stay are not permanent, but merely give the debtor a "breathing spell." Generally, courts are reluctant to grant relief from the stay until the trustee or DIP has had an opportunity to evaluate the estate and determine whether the property is needed by the debtor; however, the Code does provide procedures to allow the court's termination or modification of the stay upon request of a party in interest.

3. **Violation of the Automatic Stay.**

A party acting in violation of the automatic stay may be faced with several forms of judicial sanctions including contempt orders, damages awarded to the debtor under Section 362(h) which can be compensatory and punitive and voiding of the actions taken in violation of the stay. If any question arises as to whether a considered action is in violation of the stay, a bankruptcy practitioner should be consulted before action is taken.

B. **Preferences.**

1. **Preference Avoidance**.

As discussed, one of the underlying policies of the Bankruptcy Code is equality of treatment among creditors. In order to achieve equality, the Code gives the trustee the power to avoid certain preferential transfers made shortly before bankruptcy since these transfers give one creditor an unfair advantage and a larger distribution over other creditors. The ancillary benefit to the trustee's ability to avoid preferential transfers is that creditors are thereby discouraged

from racing to levy on the debtor's assets by judicial process on the eve of bankruptcy and hopefully, are also discouraged from literally pushing the debtor into bankruptcy.

In Code terms, a preference is:

> (1) any transfer of the debtor's property;
>
> (2) to or for the benefit of a creditor;
>
> (3) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (4) made while the debtor was insolvent;
>
> made
>
> > (A) on or within 90 days before the date of the filing of the petition; or
> >
> > (B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to receive more than such creditor would receive --
>
> > (A) the case were a case under Chapter 7 of this title;
> >
> > (B) the transfer had not been made; and
> >
> > (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Transfers which satisfy these requirements can be avoided by the trustee for the benefit of the estate. Each one of these five elements must be met for the trustee to avoid the transfer. Note that the word "transfer" is defined in the Code in the broadest possible terms to include both voluntary (*i.e.*, the granting of a security

interest) and involuntary (*i.e.*, the fixing of a judgment lien on real property) transfers.

a. **Time of Transfer.**

There has been much litigation regarding the actual time of transfer and how it is calculated. The moment of transfer is critical for computation of the preference analysis. There has been a split among circuit courts regarding when the transfer actually took place (for preference purposes) in situations where the debtor paid by check. Was it when the check was cut . . . when mailed . . . when received by the creditor . . . when it cleared the debtor's account? The Supreme Court has resolved this split by holding that a transfer is considered made for preference purposes upon the honoring of the debtor's check by the debtor's bank for payment.

b. **Review of the Elements.**

The mere fact that a transfer of a debtor's property took place within the ninety-day preference period is not enough to enable the trustee to avoid it. The Code lists five elements (see above) all of which must be present to constitute a preference. These elements are interpreted as follows:

(1) Transfer must have been to or for the benefit of a creditor.

A preference involves favoring one creditor over others, therefore, only transfers to creditors can be a voidable preference (other transfers to non-creditors may be recoverable as a fraudulent conveyance). "Creditor" is broadly defined under the Code. Guarantors are creditors since they have contingent claims against the debtor (contingent on whether or not the debtor pays the underlying obligation). Transfers that benefit a

creditor only "indirectly" may be a preference. For example, when an insolvent debtor makes payment on an obligation to a lender/creditor, and that debt is guaranteed by a third party, the third party receives "benefit" since the third party's liability is decreased.

(2) Transfer must have been for or on account of an antecedent debt (*i.e.*, pre-existing debt).

Transfers for "new consideration" are not preferences. If, for example, the debtor pays $1,000 and receives $1,000 worth of office supplies contemporaneously, there is no preference because new value (the office supplies) is received in exchange for the payment. The estate has not been diminished by the transaction. In contrast, transfers that pay on an old debt or provide security for an old debt, may constitute a preference; therefore, a major part of the preference analysis is determining when the debt was incurred and when the transfer occurred.

(3) Debtor must have been insolvent at time of transfer.

Since the purpose of preference law is to recover transfers made to creditors who were "preferred" to the detriment of other creditors, the insolvency analysis is critical. If the debtor was solvent at the time the transfer occurred — and therefore had sufficient assets to pay all of its debts in full — then there can be no "preference" of one creditor to the detriment of another.

The Bankruptcy Code creates a "presumption of insolvency" which presumes that the debtor was insolvent on and during the ninety days immediately preceding the date of the filing of the

petition. This eliminates the need for the trustee to provide evidence of insolvency. If the creditor is able to provide evidence of the debtor's solvency, however, the burden of proof shifts to the trustee who must show that the debtor was insolvent during the ninety day period at the time the transfer occurred.

(4) The transfer must have been made within the 90-day/365-day preference period.

The normal preference period is ninety days; however, if the transfer is made "to or for the benefit of" an "insider" then the preference period is one year. The rationale for the one year preference period is that an insider is in a unique position and often able to control to whom payments are made. Therefore, an insider who sees bankruptcy looming on the horizon can make sure that the debtor's obligations to him or her are paid first. The insider's unique knowledge subjects him to a full one year preference period. Otherwise, the insider would cause the preferential payment to be made and then would simply delay the bankruptcy filing for ninety days. A one year delay is much more difficult and when creditors learn of transfers to insiders, the one-year period provides an adequate period of time to determine whether to file an involuntary petition against the debtor so that the insider's preference can be recovered.

(5) Transfer must enable creditor to receive more than creditor would have received in liquidation.

The amount each creditor would receive under a Chapter 7 liquidation is reasonably easy to calculate — valuation issues notwithstanding. If a creditor would receive the same amount in a liquidation case by virtue of his distribution priority, then there can have been no preference. This section comes into play most often when a fully secured creditor has received a payment during the preference period. If the obligation was fully secured (and could not be avoided by a trustee) then the payment theoretically has freed up an equal amount of value in the debtor's assets which serve as the collateral. It is therefore impossible for a properly perfected fully secured creditor to receive a preferential payment since, upon liquidation, the collateral would be liquidated and the creditor paid from the proceeds. The actual value of the collateral may be an important topic of litigation since undervalued collateral could leave the creditor exposed to a preference recovery.

c. **Preference Defenses.**

(1) **New Value Defense.**

A transfer of the debtor's property to a creditor does not result in a preference if it was, in fact, a "substantially contemporaneous exchange" for new value. For example, if the debtor purchases new equipment and at the time of the purchase, gives the seller a check in payment of the price, there is no preference because the check is not on account of an antecedent debt, but rather is in exchange for new value. The Code defines new value as meaning "money or money's worth in goods, services or new

credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void or voidable by the debtor or the trustee under any applicable law, but does not include an obligation substituted for an existing obligation." (Section 547(a)(2)).

The new value need not necessarily be provided by the debtor. For instance, where the debtor transfers assets to a transferee which was the beneficiary of a letter of credit and the issuing bank therefore releases collateral of the debtor which secured the letter of credit, the conditions for new value for the new value exception are satisfied. In a case where the debtor purchases equipment and, at the time of sale, gives the seller a personal check for payment of the price but the seller waits three weeks to deposit the check (and deposits it within the preference period) does payment of the check constitute avoidable preference? Although payment by personal check is often is viewed as a credit transaction, such payment is "intended to be contemporaneous" and is treated as a cash transaction for preference purposes. The Code considers payment to be made when the check is delivered, unless it is dishonored. As noted above, however, when a check is received by a creditor to pay a pre-existing debt, the transfer is considered made when the debtor's bank honors the check.

(2) **Ordinary Course of Business Defense.**

The whole concept of preference recoveries is to prevent payments which are outside of the normal business dealings of

the debtor...that is to prevent some creditors from being preferred over others. The Code does not wish to disturb normal business transactions that occur between the debtor and a creditor, even up to the actual moment of the bankruptcy filing. In fact, creditors who continue to deal with the troubled debtor and who receive payments in the "ordinary course" are exempt from preference recovery. There are three elements to satisfy the Code's "ordinary course" defense as described below. The creditor has to satisfy (a) and either (b) or (c) below:

(a) The transfer was in payment of a debt which was incurred in the ordinary course of business or financial affairs of the debtor and the transferee (financial affairs refers to the non-business activities of a consumer debtor...such as the payment of monthly utility bills).

(b) Payment was made in the ordinary course of business or financial affairs of the debtor and the transferee. This factor requires that the court resolve the issue of "ordinariness" by reference to the similarity or deviance of the questioned transaction when compared to prior transactions between the debtor and the preferred creditor. For example, if historical transactions between the parties have resulted in payment being made on an average of the twenty-ninth day after the merchandise was shipped and the questioned payment was made on

the thirty-fifth day, then arguably the payment is outside the ordinary course dealings between the parties.

(c) The payment must have been made according to ordinary business terms. Some courts interpret this as referring to the practices and customs common to the industry or business in which the debtor and the transferee are engaged. Most courts however, focus their attention on the business practices and circumstances which characterize the relationship unique to the particular parties in question. The court will look at the period in which payment is normally required and determine whether or not the questioned payment was made within that period.

C. **Claims.**

Section 101(4) of the Bankruptcy Code defines "claim" as a:

(1) **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; or**

(2) **right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured...**

A claim does not necessarily have to be "fixed" or "liquidated" when the bankruptcy case is filed. The claim may arise or become vested after the filing and still be an allowed claim in the case. A person holds an equity security interest in the debtor (a share of stock in a corporation, or an interest in a partnership holds an "interest" in the debtor as opposed to a "claim", but are both essentially handled the same in the case.

2. **Filing Proofs of Claim**.

The Code gives creditors the right to file proofs of claims in a bankruptcy case. With some exceptions, any creditor who wishes to have an allowed claim in a case must file a proof of claim with the Court. Otherwise, the creditor may be unable to share in the distribution of estate assets. There are a few situations where filing a proof of claim is not warranted such as in Chapter 7 no asset cases or if a creditor is fully secured and wishes to rely solely on the value of the collateral, there will be no purpose in filing a proof of claim. Failure to file a proof of claim does not mean that the claim will not be discharged in the bankruptcy. Any claim which has been listed by the bankruptcy debtor on its schedules or subsequent amendments to the schedules will be discharged, except as exempted by the Code.

There is an official proof of claim form, and in most jurisdictions it is digital or otherwise completed online. While paper claims may be filed, the digital filing is the standard. The notice of bankruptcy filing, which is usually combined with the notice of the first meeting of creditors under Section 341 sets forth the deadlines within which all proofs of claim must be filed. The proof of claim must contain as exhibits, all supporting documents establishing the basis for the claim. Section 511 provides the rate of interest on prepetition and administrative priority tax

claims. The interest rate is the applicable rate under non-bankruptcy law. In North Carolina the interest rate is established by *N.C. Gen. Stat.* §105-360.

a. **Filing Proofs of Claim or Interest in Chapter 7 Cases.**

Section 726 of the Code provides for distribution of property of the estate. Filing a proof of claim is critical in a Chapter 7 case if any distribution is anticipated. Failure to timely file a proof of claim will bar a general unsecured creditor from participating in any distribution to its class; however, once the trustee mails out a summary of his final report before distribution, a late filed priority tax claim can be accepted if filed within 10 days of the mailing of the summary.

A creditor must file a proof of claim or interest within ninety (90) days following the date first set by the court for the initial first meeting of creditors under Section 341. If the Chapter 7 case appears to be a no asset case, the court may issue a notice informing all scheduled creditors that they are not required to file claims at the present time. The best policy, however, is to file a proof of claim before the bar date regardless of distribution predictions since assets may be subsequently discovered and brought into the estate for liquidation. It is very easy to overlook filing a proof of claim at a later date even though a second notice from the court will be sent to creditors advising them to file in the event new assets are discovered. All proofs of claims should be filed with the Clerk of Bankruptcy Court where the case is pending unless the court or local rules provide otherwise.

b. **Filing Proofs of Claim or Interest in Chapter 11 Cases.**

The debtor's listing of the amount owed to each creditor in its schedule of assets and liabilities constitutes *prima facie* evidence of the validity

and the amount of each claim. If a claim is properly listed, creditors are not required to file a proof of claim; however, if a claim is listed as a disputed, contingent or unliquidated claim, or if it has been listed in an incorrect amount or class, it is essential that a creditor file a proof of claim by the bar date established by the court unless the filing period is extended by order of the court.

Again, although a creditor may not technically be required to file a proof of claim in all Chapter 11 cases, the best policy is to file a proof of claim accurately reflecting the amount and class of claim to avoid any potential problems. By filing the proof of claim in the Chapter 11 case, a creditor is also protected in the event that the case is converted to Chapter 7. All properly filed proofs of claim in a Chapter 11 are deemed properly filed in the Chapter 7 upon conversion without need to refile the proof of claim.

c. **Filing Proofs of Claim or Interest in Chapter 13 Cases.**

A creditor must file a proof of claim within ninety (90) days following the date first set by the court for the initial first meeting of creditors. Claims of governmental units are deemed timely filed if filed within 180 days after entry of the order for relief. Chapter 13 proofs of claim, however, should if at all possible be filed before the first meeting of creditors to aid the debtor and the Chapter 13 trustee in the administration of the case. Many notices of bankruptcy filing sent out by Chapter 13 trustees' offices indicate that proofs of claim must be filed five days before the first meeting of creditors. Despite the statement in the Chapter 13 notices, however, a creditor may file a claim at any time within ninety days following the date set by the court for the initial first

meeting of creditors. A creditor who does not get a proof of claim filed before the first meeting of creditors runs the risk that his claim will not be included in the initial version of the Chapter 13 plan. Creditors must file proofs of claim to have "allowed" claims in the Chapter 13 bankruptcy. Since only allowed claims can be paid through a Chapter 13 plan, a creditor who does not file such a claim cannot receive any disbursements under the Chapter 13 plan. Upon the debtor's successful completion of the Chapter 13 plan, all debts listed by the Chapter 13 debtor are discharged, including those where no proof of claim was filed, unless the claim is exempted from discharge. All of the instructions for filing a proof of claim in a Chapter 13 case are either on the court's website or on the Notice of Bankruptcy when the case if filed.

d. **Filing Proofs of Claim or Interest in Chapter 12 Cases.**

As in the other chapters, Chapter 12 proofs of claim must be filed within ninety (90) days following the date first set by the court for the initial meeting of creditors, 180 days for governmental units. Failure to file a Chapter 12 proof of claim will result in the creditor's claim not being an allowed claim, and thus the creditor will not be able to participate in distributions under the Chapter 12 plan. Once again, for reasons discussed in the Chapter 13 proof of claim discussion, it is essential that both secured and unsecured creditors file proofs of claim within the deadline period.

3. **Objections to Claims**.

a. **Notice of Objection.**

A trustee, debtor in possession, and any other party in interest is entitled to object to claims in a bankruptcy case. Objections must be filed with

the court in writing with a copy of the objection and notice of a hearing thereon served upon the claimant. Objections to claims may be contested matters (*i.e.* handled by motion) or by an adversary proceeding.

b. **Response to Claim Objection.**

Creditors who receive notice that their claim has been objected to should always respond to the objection and appear before the court to be heard if the objection cannot be resolved with the objecting party prior to the hearing. Many times, an objection is made simply because the claimant did not attach sufficient supporting documentation to its proof of claim or because the proof of claim included unmatured interest or improper penalties. Usually these matters can be resolved without the necessity of attending a hearing. If a creditor ignores an objection, the entire claim may be disallowed.

D. **Disclosures by the Debtor.**

There are a variety of sources where the vigilant creditor can turn to gain information about the debtor at the time of filing and to observe the liquidation or reorganization process as it goes forward:

1. **Obtaining Information about the Debtor.**

a. **Petition and Related Documents**.

The Chapter 11 petition and related documents contain some basic information about the debtor and its financial condition. The petition is accompanied by a list of the debtor's 20 largest unsecured creditors who are non-insiders, including names, addresses and amounts owed. In most jurisdictions, the petition must also be accompanied by a mailing list or matrix of all creditors and other parties in interest.

b. **Schedules and Statements**.

Unless given additional time by the court, the debtor must file within 14 days of the petition a detailed schedule of assets and liabilities, schedule of current income and expenditures, statement of financial affairs, statement of executory contracts and unexpired leases, and list of equity holders. The list of equity holders may be impounded and only subject to inspection upon specified terms.

c. **General Partner Statement**.

Upon motion by the lender or other creditor, the court may order the general partner of a partnership debtor to file a statement of personal assets and liabilities. The general partner will be liable to partnership creditors for any deficiency in the event of a liquidation. Therefore, knowledge of the general partners' assets is critical to any assessment of what the creditors of the estate would receive in a liquidation scenario. It may also be important to "fix" the general partner's assets early so that the general partner does not secrete the assets and those assets remain available to satisfy judgments against the general partner.

d. **First Meeting of Creditors**.

Within 20 to 40 days following the order for relief, the United States Trustee or Bankruptcy Administrator will conduct a formal inquiry of the debtor, referred to as the "Section 341 Meeting" or "First Meeting of Creditors." The debtor's representatives will normally make a presentation explaining why the bankruptcy case was filed and then respond to questions posed by the trustee and by creditors. The debtor's representatives are under oath, and the trustee (or BA) will generally make a digital recording of the proceedings which can later be copied or

replayed by parties in interest. The meeting may be continued from time to time to allow a forum for periodic updates or for full questioning about the debtor's schedules and statements.

e. **Written Reports**.

Chapter 11 debtors are generally required to file monthly operating statements covering profit and loss, sales, expenditures, cash flow, accounts payable, and accounts receivable. Some jurisdictions require more detail than others. The debtor is also required to keep a receipt and disbursement record and, if ordered by the court, to file a complete inventory of property within 30 days of the order for relief.

f. **2004 Examination.**

Under Bankruptcy Rule 2004, the court may grant the motion of any party to examine the debtor (or any other party) under oath about the acts, conduct, property, liabilities, or financial condition of the debtor, any matter that might affect the administration of the bankruptcy case, or the debtor's discharge. This broad right to examination includes subpoena power and the right to production of documents.

g. **Depositions and Other Discovery**.

For litigation matters, the Bankruptcy Rules incorporate most of the Federal Rules of Civil Procedure. This means that in adversary proceedings and other contested matters, the debtor may be deposed, required to produce documents and respond to other discovery requests.

h. **Examiner's Report**.

If an examiner is appointed in a case, he will likely file one or more written reports (and/or testify in court) providing information about the debtor.

i. **Notice**.

The Bankruptcy Code and Rules provide for notice to creditors and other interested parties. If a creditor is included on the mailing matrix or list of creditors filed with the court, notice will be given on some matters as a matter of right; however, for maximum notice, a written request should be filed with the court by the local government's counsel or other agent asking to be served with all pleadings, motions, applications, notices, and other court filings. A copy of the request should be served on the debtor's counsel. This is important for governmental taxing authorities as under Section 505, a debtor or trustee can seek a determination request on taxes. Unless a notice is filed by the authority stating where bankruptcy pleadings are to be sent, the trustee or debtor can send the determination notices to the address for filing returns.

j. **Disclosure Statement**.

In a Chapter 11 case, the debtor or other proponent of a plan is required to file, serve and obtain court approval of a disclosure statement. To be approved, the statement must provide "adequate information" about the reorganization plan. "Adequate information" means information that will enable a hypothetical reasonable investor to make an informed decision about the plan. The kind and extent of information will vary from case to case and depends on the nature and history of the debtor, the debtor's books and records, the complexity of the plan, the ability of the draftsman, and the size of the case. Lenders can often obtain additional information from the debtor by objecting to inadequacies in the disclosure statement. The debtor may either voluntarily cure the

inadequacies by supplement or amendment or be ordered to do so by the court.

k. **Plan.**

Plans are filed in Chapter 9, 11, 12 and 13 cases. Plans set forth classes and treatment of creditors in the debtor's case, the disposition or retention of assets, satisfaction of liens, sales of assets, assumption or rejection of executory contracts and leases, injunctive relief and professional releases. Because many tax claims are nondischargeable and entitled to priority payment, the plan has to provide for satisfaction of the tax claims. Deferred payments in a Chapter 11 plan for debtor's prepetition liability for unsecured priority taxes and secured taxes cannot extend beyond five years from date of order of relief and the tax authority must be treated no less favorably then the most favored non-priority unsecured claimant other than a convenience class of creditors in the plan. If the governmental authority holds an administrative priority tax claim, provision for payment in full of the claim must be made in the plan. Chapter 11 plans sometimes set up trusts to administer assets or pursue litigation and recoveries. The creditors vote for or object to a plan and the court determines whether or not to confirm the plan. In Subchapter V the trustee is he disbursing agent in contested plans but is discharged and does not make disbursements in consensual Subchapter V plans.

l. **Public Records.**

Public records, including filings by the debtor (or affiliate of the debtor) with the Securities Exchange Commission, both pre- and post-petition, can be a rich source of information.

VI. SPECIFIC ISSUES IN BANKRUPTCY FOR LOCAL GOVERNMENTS

A. **Taxes in Bankruptcy.**

1. ***Ad valorem* taxes – secured, priority or unsecured claims?**

While most debtors' counsel remember to schedule the State departments of revenue and the Internal Revenue Service (IRS) as a creditor on the bankruptcy schedules, it is rare for counsel to list local municipalities with taxation power as creditors on the schedules, much less in the notice matrix or even budgets provided during a bankruptcy. Most states have a form of local taxation of real or personal property known as *ad valorem* taxes. If the debtor owns real or personal property, it is likely he or she owes taxes on that property to one or more local government entities. Liability for *ad valorem* taxes arises on a certain date each year. It is not unusual for a debtor to think that because they paid a bill and have not received a new bill that they do not owe taxes. Debtors' counsel forget that *ad valorem* taxes are owed as the assessment date will owe taxes for that year. While taxes may be an unliquidated amount, the liability is not contingent and current year taxes will be a prepetition claim if bankruptcy is filed after the assessment date. If local *ad valorem* tax creditors are not listed on the bankruptcy schedule then the authorities may not get procedural due process notice and tax debts may not be discharged and certain orders of the bankruptcy court may not be effective against them. Ad valorem taxes are secured by a lien on the property taxed. By definition, they are secured claims and not priority claims under Bankruptcy Code Section 507(a)(8) which only deals with unsecured claims. Interests in property are created and defined under state law, and tax liens, like other liens, should generally pass through a bankruptcy unaffected. Because states have strong interest in protecting the primary source

of revenue for local governments, in most states, *ad valorem* tax liens are the highest priority liens, senior even to purchase money or other pre-existing liens. In North Carolina, the lien for *ad valorem* taxes attaches to the property of the land owner at the time the taxes are levied. The lien for taxes is superior to all other private liens whether recorded before or after the tax levy. It is not necessary for the county or municipality to file anything in the clerk's office or register of deeds.

Local tax authorities' secured claims are similar in many respects to those of other secured creditors and they are entitled to the same treatment and benefits as other secured creditors. While it is common for a debtor to provide for "adequate protection" for consensual secured creditors in post-petition financing and sales of property, it is equally common for liens and interests of local governments to be forgotten. The preparer of the bankruptcy proof of claim for unpaid taxes needs to examine the factual base of the claim to make sure all hoops have been jumped through under state statutes in order to properly prepare the proof of claim.

2. **The Automatic Stay in the Taxation Process**

Debtors often complain when, after bankruptcy filing, they receive a tax bill, valuation notice, delinquency notice or other notice required under state or local law. Debtors and their counsel may argue that such notices and bills violate the automatic stay under Section 362 of the Bankruptcy Code; however, when drafting Section 362, Congress was for once thinking of local governments and there are not one but two exceptions to the automatic stay that are specifically designed to protect *ad valorem* tax authorities. Section 362(b)(9)(D) of the Bankruptcy Code provides that the filing of a bankruptcy case does not stay the

making of an assessment for any tax, and issuance of any notice and demand for payment of such an assessment. Section 362(b)(18) of the Bankruptcy Code provides that creation or perfection of a statutory *ad valorem* tax lien or special assessment on real property does not violate the automatic stay. As a practical matter, the bankruptcy filing only operates as a stay of a local tax authority's right to seize, sue, foreclose or otherwise act to collect a debt – not to assess the tax or impose the related lien from property of the debtor or of the estate.

3. **Administrative Priority Expenses – Post-petition Taxes**

While bankruptcy is a process that gives the debtor a "fresh start", it does not give a blank pass to the debtor or otherwise provide an advantage in ongoing operations, at least as far as taxes are concerned. As a general rule, debtors and trustees that own property must operate in compliance with non-applicable non-bankruptcy law, including tax laws pursuant to 28 U.S.C. Sections 959 and 960. However, while most debtors in possession and trustees remember to file IRS income tax returns and pay state sales, employment and income taxes owed post-petition, they often fail to file returns and timely pay post-petition *ad valorem* or other local taxes. The failure to comply with state and local tax laws results in added penalties to the amounts owed. Taxes owed by the debtor's estate post-petition, as well as any penalties thereon, are entitled to administrative expense status pursuant to Section 503(b) of the Bankruptcy Code. Section 503(b)(1)(B)(i) provides that post-petition *ad valorem* taxes qualify as administrative expenses. In the Eastern District of North Carolina, *ad valorem* taxes for the current tax year may be treated as a pre-petition claim and not as an administrative expense. *See In re Members Warehouse, Inc.*, 991 F. 2d. 116, 118-119 (4th Cir. 1993). If the debtor fails to pay local taxes post-petition, what

steps do local tax authorizes have to take? Actually, tax authorities are not required to file administrative expense claims or requests for payment as regular administrative expense claimants have to do in order to have these amounts deemed "allowed." See Section 503(d)(1)(D) of the Bankruptcy Code. The failure to timely pay taxes owed after the bankruptcy petition date or to file a tax return including *ad valorem* property tax returns or "renditions" can be grounds for dismissal of a Chapter 11 case. See Section 1112(b)(4)(I) of the Bankruptcy Code. In addition, a trustee or debtor in possession in a small business case has to timely file all "tax returns and other required government filings" as well as timely pay all taxes entitled to administrative expense priority in order to avoid providing cause for dismissal of the case. See Section 1116(6) of the Bankruptcy Code. In addition, because the post-petition taxes are secured, a Chapter 11 plan should provide for the retention of such tax liens as well as for the liens for prepetition taxes. The plan should provide for post-petition taxes to be timely paid in the ordinary course of business pursuant to applicable non-bankruptcy law.

B. **Preference Claims Against Local Governments and Utility Providers.**

As discussed previously, Section 547 of the Bankruptcy Code provides a mechanism by which a trustee or debtor in possession can recover monies back into the debtor's estate which were paid to a creditor on an antecedent debt by the debtor in the ninety days prior to bankruptcy filing while the debtor was insolvent that results in the creditor getting more than it would get in a Chapter 7 case. All of these elements of a preference must exist in order for preferential payments to be recovered. As we have discussed, the debtor has to file a statement of financial affairs early in its bankruptcy case which, among other things, lists all payments made within ninety days prior to bankruptcy filing and to whom the payments were made. The time period for a debtor or trustee to seek

recovery of a preference is later of the earlier of two years from the date of the bankruptcy filing when the order for relief is entered or, if the case converts to a Chapter 7 within the two year period, an additional one year from the date the order is entered appointing a trustee in the case. The debtor or trustee will normally send out a demand letter threatening to file an adversary proceeding if the creditor does not refund a prepetition payment received in the ninety days prior to the bankruptcy filing. Local governments often receive such demands for return of payments made in alleged preference satisfaction of *ad valorem* tax, utility payments, or other similar payments. If the debtor or trustee is coming up against the statute of limitations, then an adversary proceeding will be filed for recovery of the payments.

1. **Preference Defenses for Tax Payments**

As we discussed, the Bankruptcy Code provides for several defenses: (1) if the creditor provides new value after receipt of the payment from the debtor, (2) if the payment was made in the ordinary course of business between the debtor and the creditor, or (3) if there was an contemporary exchange of payment and services, then preference exposure can be limited or totally dismissed. In addition, if the creditor can defeat any of the elements of a preference, it has a defense to liability. For example, a payment of a secured tax claim is not an avoidable preference because (1) the tax authority provides new value by releasing the lien on the property, (2) it is not a payment of antecedent debt if the taxes are paid before the tax becomes delinquent, (3) such payment is not more than the tax authority would otherwise receive in a Chapter 7, case because secured claims are generally paid in full, and (4) the taxes are a debt incurred and paid in the ordinary course of business. A statutory tax lien can only be avoided, if at all, pursuant to Section 545 of the Bankruptcy Code and release of a tax lien constitutes the receipt of "reasonably equivalent value" for the payment received.

Because the statute defines a due date for taxes as the last date they may be paid before becoming delinquent, a timely payment of taxes can never be a preference.

2. **Preference Defenses for Utility Providers**

For utility payments, the utility provider is usually providing goods and services to the debtor up to the date of the bankruptcy filing so defenses such as new value come into play. The bottom line is that a local government should not automatically pay a preference demand without examining all defenses and whether any of the elements of a preference can be destroyed.

C. **Utilities**

1. **Section 366**

Section 366 of the Bankruptcy Code puts utility providers in more of a driver's seat in negotiating and determining adequate assurance of future utility payments. As part of their first day motions, debtors-in-possession ("DIP") routinely file a motion to establish procedures to determine adequate assurances of payment to utilities. Under Section 366(a) of the Bankruptcy Code, a utility is prohibited from altering, refusing or discontinuing post-petition services solely on the basis of commencement of a bankruptcy case or that a debt is owed by the debtor to such utility for service rendered before the order bankruptcy which was not paid when due. Section 366(b) however, did authorize a utility provider to alter, refuse or discontinue service if neither the trustee nor the debtor, within 20 days after the date of the order for relief, furnished adequate assurance of payment neither Section 366(a) or (b) required a monetary deposit or any other monetary security for services after such date.

2. **Section 366(c)**

Section 366(c) gives utility service providers additional protection and leverage. This Section 366(c), only applicable on Chapter 11 proceedings, provides that:

> A utility referred to in subsection (a) may alter, refuse or discontinue utility service if, during the 30 day period beginning on the date of the filing of the petition, the utility does not receive from the debtor or the trustee adequate assurance of payment for utility service *that is satisfactory to the utility*. (emphasis added).

Further, under Section 366(c), assurance of payment was defined as "1) a cash deposit; 2) a letter of credit; 3) a certificate of deposit; 4) a surety bond; 5) a prepayment of utility consumption or 6) another form of security that is mutually agreed upon by the utility and the debtor or trustee. An administrative expense priority claim is specifically excluded from the definition of "assurance of payment". Note that Section 366(b) only included in definition of assurance of payment and still can provide an administrative expense claim as adequate assurance of payment to utility during the first 20 days of the bankruptcy case. Section 366(b)(3)(A) also specifically excludes from consideration of whether an assurance of payment is adequate, the 1) absence of security before the date of the filing of petition, 2) the payment by the debtor of charges for utility services before the filing of petition and 3) the availability of an administrative expense claim. The debtor-in-possession still has the ability to file a motion with respect to section 366(c)(3)(A) requesting modification of adequate assurance payment requirements. In all practicality, the DIP would have to contact all of the utility providers, obtain from them what they thought was adequate assurance of payment and then either meet the utilities demands or obtain an order within 30 days after filing of the bankruptcy petition modifying that amount in order to continue to receive service.

3. **Negotiating Tips Under Section 366(c)**

When negotiating adequate assurance payments, it is imperative that a utility provider act as quickly as possible upon receiving notice of a bankruptcy filing in order to be able to object to a first-day motion and other expedited hearings commonly held in Chapter 11 bankruptcy cases, particularly in cases filed in Delaware or in the Southern District of New York. Other items to consider when negotiating adequate assurance payments is determining whether the utility has an existing executory contract with the debtor to provide utilities.

D. **Utility Providers And Executory Contracts**

1. **Section 365**

Section 366 is not the only provision that may be applicable to the relationship between a debtor and its utility providers. Some utilities may require customers to enter into a contract which provides terms such as price, length of the contractual relationship, usage quotas, etc. as a condition precedent for receiving service. If the utility has a contract with a debtor that files Chapter 11 and that contract is executory as defined in the Code, then the debtor not only has to satisfy the provisions of Section 366 as previously discussed, but must also consider the ramifications of assuming or rejecting the executory contract with the utility provider under Section 365 of the Bankruptcy Code. Section 365(a) of the Bankruptcy Code, provides that the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor. Timing for assumption or rejection of an executory contract that is not a non-residential commercial lease is at the time of plan confirmation unless otherwise agreed by the parties or the creditor moves to have the contract assumed or rejected earlier in this case and the court grants such motion. The Bankruptcy Code has not defined the "executory contract" but most courts have determined

that a contract is executory if the "obligations of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other".

If the debtor has defaulted on any monetary term of an executory contract, the trustee cannot assume such contract unless, at the time of the assumption, the trustee cures or provides assurances of future cure. Rejection of an executory contract not previously assumed constitutes a breach immediately before the date of the filing of the bankruptcy petition. Such rejection and breach gives rise to a prepetition unsecured claim and generally excuses the other party from future performance. If the contract is assumed in the case and later rejected, damages can be a post-petition administrative priority claim. If a contract is assumed, any potential preference liability goes away as the debtor would have had to make the alleged preference payments to cure the contract. If the utility provider does not have a contract with the debtor, then Section 365 does not apply. Also, if the utility is required under some other law to continue to provide service to the debtor, perhaps because it is a monopoly, then notwithstanding rejection of the executor contract under bankruptcy law, the utility may still have to provide service to the debtor. If there is a breach of an executory contract for utilities, and there is no state law or other law requiring service to debtor, then if the contract is rejected, theoretically to consider the utility could discontinue service.

2. **Interplay of Sections 365 and 366**

Unfortunately, there is also Section 366 of the Bankruptcy Code. As discussed previously in this manuscript, a utility cannot discontinue service to the debtor if the only reason to shut off services is the filing of the petition or failure to pay prepetition debt. It can be argued that a breach of contract by the debtor who

says it will not perform under the contract in an independent cause not based on filing of the petition or failure to pay a prepetition debt and may be a valid reason for terminating utility services. Some bankruptcy courts, however, have rules that, notwithstanding rejection of an executory contract, a utility has to continue service if adequate assurance of payment under Section 366 has been satisfied and if there are no post-petition defaults. Considering the interplay of Sections 366 and 355, the utility provider may wish to deal with both issues together early in the case. The utility may request monetary adequate assurance payment under Section 366 in an amount to cover any exposure the utility has post-petition. For example, if the utility's billing cycle is 30 day and each bill is not due 30 days after the billing date, the utility has a 60-day exposure and should request at least that much protection. However, if there is an executory contract with the debtor, the provider should consider talking to the debtor about assumption of the contract and be aware that the debtor may have additional leverage in negotiating a lower upfront payment in exchange for cure of the utility contract. The utility provider should also be aware of Bankruptcy Rule 6003 which provides that, except to the extent necessary to avoid harm, the court shall not within 20 days after filing the petition grant a motion to assume an executory contract. However, on agreement of the utility, the debtor and the utility can agree to extend the 30 day period under Section 366 by which the debtor is required to provide adequate assurance of payment in order to give the parties time to work out a deal resolving the utility issues under Section 366 and the executory contract issues under Section 365. If the utility provider is facing a large preference exposure later in the bankruptcy case, this deal might make sense.

E. Utilities as Providers of Goods Under Section 503(b)(9) of the Bankruptcy Code

1. Goods or Services Provided by a Utility

Section 503(b)(9) provides for administrative expense priority for certain claims. Section 503(b)(9) applies to any entity providing, "goods" to the debtor within 20 days before the bankruptcy petition date in the ordinary course of business. A determination of a 503(b)(9) claim is made pursuant to notice and a hearing. While Section 366 of the Bankruptcy Code did give additional protections to utility companies to ensure payment of post-petition claims, Section 366 does not address the treatment of a utility provider's prepetition claims. Instead, a utility's prepetition claim is treated no differently than any other general unsecured claims, even if it is a claim for which a deposit is usually given. Utility providers have recently sought administrative priority under Section 503(b)(9) claiming that natural gas, electricity and water are "goods" that should be covered by and protected by Section 503(b)(9).

2. **Success for 503(b)(9) Claims?**

The results in bankruptcy courts for utility companies who have attempted to obtain administrative priority under Section 503(b)(9) of the Code have been varied. The express language of Section 503(b)(9) provides that "goods" and no other type of service provided to the debtor in the 20 day period before the petition date are entitled to an administrative expense claim. The courts have looked at the definition of "goods" under the Uniform Commercial Code. Pursuant to Section 2.107 of the Uniform Commercial Code ("UCC") a "contract for the sale of minerals or the like (including oil and gas) or a structure or its materials to be removed from realty is a contract for the sale of goods within this article." Thus, bankruptcy courts have found that natural gas is a "good" under Section 503(b)(9); however, the provider's entitlement to an administrative expense claim for natural gas is limited to just that – the value of the gas - with no compensation for infrastructure or delivery. What about electricity? Courts

have held that entities providing the medium for telephone calls and the internet are providing not a good but a service, so no Section 505(b)(9) claim for telephone or internet service may not be allowed. Provision of water to a debtor has been found to be a "good;" however, the value of the delivery of such water is not entitled to administrative priority status. Some debtors have attempted to defend against a utility provider's administrative expense claim under Section 503(b)(9) by asserting that the utility companies should not be entitled to the protections of both Sections 503(b)(9) and 366; however, it appears Congress was silent and did not address this issue or ban this potential double benefit to utilities so, at this point, a utility provider should consider whether it wants to make a claim under Section 503(b)(9) for the value of the natural gas, water and electricity provided to the debtor. If so, it should be prepared to file a motion under Section 503(b)(9) for a determination of an administrative expense priority claim for value of the goods it provided to the debtor and that the debtor received within the 20 days prior to bankruptcy. If the utility provider wins on this issue, it means that it has a higher priority payment for those goods provided within the 20 day period instead of having all of its prepetition claim regulated to the status of a general unsecured creditor.

F. **Utilities Providers in Consumer Bankruptcies.**

1. **Consumer Bankruptcy and Section 366**

The purpose and policy of Section 366 is to prevent the threat of termination from being used by a utility provider to collect prepetition debts by not forcing the utility to provide services for which it may never be paid. As we have discussed, the Code places the onus of offering adequate assurance of payment on the debtor, but what about individual consumer debtors? Practically, to the consumer debtor in Chapter 7 and 13 cases, most utility companies take the

initiative of sending a letter setting forth the adequate assurance demand. As we have discussed, assurance of payment is limited by Section 366 to a cash deposit, letter of credit, certificate of deposit, surety bond, pre-payment of utility consumption or other form of security that is mutually agreed upon between the debtor and the utility. In consumer cases, the request a utility should make is always for a security deposit in cash as most consumer debtors are unlikely to be able to provide a bond or letter of credit. Remember that a utility provider can automatically terminate service without court approval if the adequate assurance is not timely provided to it as Section 366(b) has been read by courts as an exemption to the automatic stay allowing the utility to alter, refuse or discontinue service for failure to provide adequate assurance of payment without having to first seek recourse to the bankruptcy court. As discussed in this manuscript, Section 366 does not limit the amount a utility can ask for a deposit, however, bankruptcy courts in consumer cases have generally deferred to state regulations governing security deposits for consumers. Unlike Chapter 11 cases, in a Chapter 13 or 7, a court will generally look at prepetition payment histories in determining the reasonableness of a deposit and at whether a debtor is current on his bill at the time of filing. The court can look at the debtor's history of missed or late payments prepetition and can also look at debtor's ability to pay going forward. The debtor's lack of capacity to pay for future bills can be established by the utility if it looks at the debtor's schedules filed in the bankruptcy case. For example, the utility can compare the debtor's income on Schedule I to expenses on Schedule J or look at Schedule F to see how many of the debtor's living expenses were charged to credit cards before filing of the bankruptcy. If the debtor's expenses exceed his or her income or the debtor has lived on his or her credit cards to pay expenses, that is good evidence that the utility company

can use to show the court debtor's inability to pay for future utility service, necessitating the deposit request.

2. **Utility Defaults in Consumer Bankruptcy**

Assuming the consumer debtor has paid the security deposit, what happens when the debtor falls behind in payments? Can the utility start termination proceedings without first obtaining relief from the automatic stay under Section 362? In consumer Chapter 7 and 13 cases, bankruptcy courts have directly addressed this issue and concluded that utilities are not required to obtain relief from stay before terminating a debtor for failure to pay post-petition bills. In Chapter 7 cases, courts have routinely allowed utilities to terminate service for post-petition defaults without obtaining relief from stay as long as the utility follows its own state law for termination proceedings. In Chapter 13 cases, bankruptcy courts have specifically authorized termination of service in Chapter 13 cases without relief from the automatic stay; therefore, under Chapter 7 and 13 cases, the utility provider can terminate service for nonpayment of the deposit and can terminate for nonpayment of post-petition bills without first obtaining relief from the automatic stay.

G. **Environmental Issues and Enforcement by Local Governments Units in Bankruptcy Proceedings.**

1. **Automatic Stay**

As noted earlier in the manuscript, Section 362(b)(4) exempts from the automatic stay actions and proceedings to enforce police and regulatory powers of a governmental unit. The policy of the Code is to permit regulatory, police and criminals actions to proceed in spite of the automatic stay and to permit enforcement of resulting judgment or orders, other than monetary judgments. Examples of exemptions from the automatic stay under Section 362(b)(4) include

(1) razing of condemned buildings; (2) injunctions against the debtor to enforce environmental laws; (3) enforcement of zoning ordinances; (4) rent regulation enforcement; (5) enforcement of minimum wage laws and employment nondiscrimination laws; and (6) enforcement of water quality control standards.

2. **Considerations by Bankruptcy Court in Allowing Environmental Actions to Proceed**

To determine whether the action the governmental unit wants to take is exempted from the automatic stays of police regulatory actions or collection action, bankruptcy courts have developed two tests to judge the government's actions: (1) Is the government unit pursuing a matter of public safety and welfare rather than a governmental pecuniary interest? and (2) Is the governmental action designed to effectuate public policy rather than to adjudicate private rights?. Basically enforcement of any monetary judgment under police and regulatory enforcement actions remain subject to the automatic stay. Thus, bankruptcy courts have concluded that Section 362(b)(4) permits a government unit to fix civil liability and to enforce present compliance with the environmental laws, even where an expenditure of funds may be necessary as long as no attempt is made to collect on a monetary judgment based upon past violations; however, the Supreme Court has held that to require an individual debtor to clean up environmental damage is a "claim" and the debtor's cleanup obligation is "debt that could be" discharged in bankruptcy. In that case, he found that the state did expect the debtor to engage in the cleanup themselves; rather it expected the debtor to expend funds to effect the cleanup. As the debtor's obligation could be satisfied by the payment of funds, the state's action was a claim that could be discharged. Since that Supreme Court case, the question of whether a cleanup obligation can be discharged involves consideration of issues, including whether

a particular cleanup order or obligation constitutes a "claim", and when the "claim" a arose as well as the adequacy of notice. It comes down to the balance of the government's need to enforce its police and regulatory power with the estate's needs to preserve its assets for the reorganization of the debtor. Governmental units should be prepared to face a stiff fight in bankruptcy court over cleanup costs and the debtor's obligation to perform this cost.

3. **Strategy in Bankruptcy Court to Enforce Environmental Laws**

There are some other tools in the arson of local governments related to environmental issues. In a Chapter 7 case, under Section 707, a case can be dismissed for failure to comply with regulations protecting the environment. For example, when the debtor is responsible for an environmental hazard and the trustee would be responsible for bringing the party into compliance with state and federal regulations, dismissal of the Chapter 7 case and permitting the appointment in a non-bankruptcy forum of a suitable qualified trustee to manage the hazard, may be appropriate since the health, safety and wellbeing of the community is affected. Section 707 provides that dismissal may only be granted after a notice and the hearing and may only be for cause. In a Chapter 11 case, the governmental unit has power in that the commencement of a Chapter 11 case does not exempt a trustee or a debtor-in-possession from operating the business in accordance with other laws. Pursuant to 28 U.S.C. Section 959(b), a trustee and debtor-in-possession is required to "manage and operate the property…. according to the requirements of the laws of the state in which the property is situated." A trustee or debtor-in-possession is therefore obligated to comply with environmental laws and regulations while operating its property. This obligation includes hazardous waste management and disposal. Governmental units should also look carefully at a debtor's plan. Under Section 503(b)(1)(A), two types of

environmental claims are often accorded administrative expense priority. The first category is cleanup costs assessed or incurred post-petition on property owned by the debtor which is contaminated with hazardous materials. The second category is civil fines and penalties arising from post-petition violations of state or federal environmental laws or regulations in the operation of the debtor's business. The theory is that the cleanup costs provide an actual and necessary benefit for purposes of preserving the estate. Courts have denied administrative expense priority for criminal penalties imposed post-petition, even though based on post-petition conduct. However, administrative priority has been granted by the bankruptcy courts for civil penalties assessed for post-petition violation of environmental laws. Decisions allowing administrative expense claims for post-petition cleanup costs draw support from the Supreme Court's decision in *Mid-Atlantic National Bank, the New Jersey Department of Environmental Protection,* 474 U.S. 494, 106, S.Ct. 755, 88 L.Ed. 859 (1986). In that case, the Supreme Court ruled that a bankruptcy trustee could not abandon property contaminated with hazardous waste in contravention of state or local laws designed to protect public safety or health. Based on that reasoning, a governmental unit should be prepared to argue that a trustee of debtor cannot abandon property contaminated with toxic substances that pose a significant hazard to public health, and that expenses to remove the threat posed by the toxic substances are necessary to preserve the estate. Governmental units which know of environmental problems in a bankrupt debtor in their municipality, should make sure the debtor is monitored post-petition and be proactive if further environmental issues arise post-petition.

H. **Miscellaneous Bankruptcy Provisions Affecting Local Governments.**

1. **Revenue Stamps or Similar Transfer Taxes.**

Section 1146(i) and Section 1231(i) deal with stamp taxes or similar transfer taxes normally imposed at the time of sale or transfer of property and both sections provide that such taxes may not be imposed on the issuance, transfer or exchange of a security or making or delivery of an instrument of transfer under a Chapter 11 plan. In the past, debtor have successfully argued that this exception should be applicable to taxes imposed on the sale or transfer of real property pursuant to a Section 363 sale of all or substantially all of debtors outside of a plan. The exception has also been tried for sales and use taxes for personal property. Taxing authorities argued that the exception only applies if a sale or transfer of property has been made pursuant to a plan. The Supreme Court has now agreed with the taxing authorities and held that the exception does not apply to Section 363 sales. *See Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 128 S. Ct. 2326 (2008)

2. **Section 346.**

Section 346 prevents a bankruptcy filing from (1) resulting in a new taxable estate for federal but not for state and local, (2) conforming federal, state and local tax consequences of property transfers from a debtor to the estate (or vice versa), (3) preventing tax consequences from being imposed on discharged income unless also subject to such tax by the IRS and (4) generally requiring states and localities to follow the same rules on reducing tax attributes to reflect untaxed discharged income as the IRS.

3. **Section 505.**

Section 505(a) of the Bankruptcy Code infers broad authority on the bankruptcy court to determine any unpaid tax liability of the debtor that has not been contested or adjudicated by a judicial or administrative tribunal prior to a bankruptcy filing. Some debtors have attempted to contest tax liabilities from

years prior to the bankruptcy filing and, although local and state taxing jurisdictions have objected to such actions as not being timely, bankruptcy courts were not receptive to that argument. If the liability became fixed and the debtor fails to timely contest it outside of bankruptcy by the time of bankruptcy filing, the debtor cannot contest the liability in bankruptcy.

4. **Section 363 Sales.**

The Bankruptcy Code allows a debtor to sell all or substantially all of its assets outside of a plan, after notice and hearing. Normally, Section 363 sale motions provide that all liens on the assets to be sold will transfer to proceeds to the property can be sold free and clear of any liens, encumbrances or claims. When a governmental authority receives notice of a Section 363 sale in a bankruptcy case, it should make sure that the players in the case know of tax liens on the property to be sold. If necessary, a short objection to the sale should be filed by the governmental entity to make sure sufficient sale proceeds are allocated to the payment of its claim.

5. **Chapter 11 Plan Default.**

As noted, tax claims are priority claims or secured claims and must be paid in full under a Chapter 11 Plan. Section 1142 of the Code directs the debtor to carry out the terms of the plan and to comply with the order confirming the plan. Unfortunately, not all debtors are able to consummate successfully a plan of reorganization. If a debtor defaults under the terms of the plan and fails to make its plan payments, what is the remedy for the governmental entity? Upon default, the plan should first be reviewed to verify the terms and make sure there are no restrictions in the plan language on the ability of the government unit to act. If no restrictions and the debtor is in default, then the taxing authority can proceed

to foreclose on prepetition and post-petition amounts without further permission of the bankruptcy court.