Improving The Odds Of Repayment In Bankruptcy

Malhar S. Pagay

When a creditor finds out that a customer or vendor has filed a bankruptcy case, it may want to file a Proof of Claim immediately. But acting hastily may waive the creditor's important rights or overlook other remedies that could result in a greater recovery on account of its claim.

IT HAPPENS every day. Your client receives a notice in the mail or is told by one of its customers or vendors that it has filed for bankruptcy protection and won't be paying its open invoices, leaving your client with a potentially significant unpaid receivable. Your client is advised that, upon the filing of the customer's or vendor's bankruptcy case, an automatic court injunction arises (called the "automatic stay") that prohibits your client from taking any action to collect the receivable. In many cases, your client has a procedure in place to deal with this

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Malhar S. Pagay is a shareholder of the national bankruptcy boutique firm of Pachulski, Stang, Ziehl, Young, Jones & Weintraub P.C. The firm has offices in Los Angeles, San Francisco, Wilmington, Delaware and New York.

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unfortunate event: Typically, someone in the company's accounting, accounts receivable, or collections department will fill out a standard bankruptcy claim form (called a "Proof of Claim"), mail it to the bankruptcy court, and the receivable sometimes will be "written off" and forgotten, even in cases where the amount of the debt is substantial. Months or even years later as the bankruptcy case runs its course, the company may be surprised to receive a check representing a fraction of the amount owed.

However, simply filing a claim and hoping for the best can harm your client in potentially two ways:

- First, filing a Proof of Claim can undermine litigation strategy if there is a dispute about the amount owed and, in cases where the debtor may also assert claims against your client, can expose your client to jurisdiction in an undesirable forum;
- Second, in some cases, your client may be able to take additional steps to improve its position in the bankruptcy case and enhance the likelihood of greater or even full payment on account of its claim. Also, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 ("BAPCPA"), which became law on April 20, 2005, amended certain provisions of the Bankruptcy Code that, in some cases, may augment or allow greater access to certain creditor remedies that can be pursued for the benefit of your client.

THE BANKRUPTCY CLAIMS PROCESS • The focus of a bankruptcy case is the treatment and discharge of "claims." The United States Bankruptcy Code defines a claim as a "right to payment...or right to an equitable remedy for breach of performance if such breach gives rise to a right of payment," whether or not such rights are "reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured." 11 U.S.C. §101(5).

Allowance And Disallowance Of Claims

Claims may either be "allowed" or "disallowed." The holder of an allowed claim has certain rights in a bankruptcy case, whereas the holder of a disallowed claim generally has none. The process of allowing a claim depends on the type of bankruptcy case that is pending.

Chapters 7 or 13

Creditors in chapter 7 liquidation cases are required to file a Proof of Claim to have an allowed claim. If a proof of claim is not the subject of an objection, the claim is allowed. In a chapter 7 or 13 bankruptcy case, with certain exceptions, Proofs of Claim must be filed within 90 days of the first meeting of creditors, also referred to as the "341(a) meeting" (named after the section in the Bankruptcy Code that provides for the meeting). Fed. R. Bankr. P. 3002(c); *see* 11 U.S.C. §341(a).

Chapter 11

The claims allowance process in a chapter 11 case is substantially different. In a chapter 11 case, a creditor need not file a proof of claim if the entity in bankruptcy (called the "debtor") lists the claim in its Schedules of Assets and Liabilities and it is not scheduled as "disputed," "contingent," or "unliquidated." 11 U.S.C. §1111(a). If the claim is not scheduled or if it is scheduled as disputed, contingent, or unliqui-

dated, the creditor must file a Proof of Claim to have an allowed claim. Generally, the timing of the deadline for submitting claims in a chapter 11 case is within the bankruptcy court's discretion: The debtor will file a motion with the bankruptcy court requesting that it set a "bar date," which is a deadline by which all Proofs of Claim must be filed.

Claims may be disallowed on any basis that would render them unenforceable under otherwise applicable non-bankruptcy law, and are also subject to various Bankruptcy Code limitations on certain types of claims, such as rent, employment, and insider claims. *See* 11 U.S.C. §502(b).

Pending Litigation

If claims are the subject of pending litigation when the bankruptcy case is filed, the bankruptcy court will generally have discretion to lift the automatic stay to permit the claim to be determined in the pending litigation, or to maintain the stay in force, effectively requiring the claim to be litigated in the bankruptcy court.

WHETHER TO FILE A PROOF OF CLAIM • Filing a Proof of Claim is the only mechanism through which a creditor may recover money from a bankruptcy "estate"—the estate is the legal entity created upon the bankruptcy filing in which all of the debtor's property is held during the bankruptcy case. However, where litigation regarding a claim is pending, the decision to file a Proof of Claim carries added weight: Filing a claim submits the claimant to the equitable jurisdiction of the bankruptcy court, and waives the right to trial by a jury. *See Katchen v. Landy*, 382 U.S. 323 (1966). As one court has noted:

"When a creditor submits to bankruptcy court jurisdiction by filing a proof of claim in order to collect all or a portion of a debt, it assumes certain risks. For example, the creditor loses the right to a jury trial on any counter-claims filed by the debtor or the trustee [in bankruptcy]. In addition, the creditor loses previously-held rights to assert "legal claims" against the debtor…; bankruptcy "converts the creditor's legal claim into an equitable claim to a pro rata share of the res [of the bankruptcy estate]…" *Hong Kong & Shanghai Banking Corp. v. Simon (In re Simon)*, 153 F.3d 991, 997 (9th Cir. 1998) (citations omitted), *cert. denied*, 525 U.S. 1141 (1999).

Therefore, when a claim is in dispute, the creditor should consult with counsel handling the litigation of the claim before filing any Proof of Claim. Strategically, counsel may believe trial in a non-bankruptcy forum or trial before a jury to be more advantageous to the creditor than subjecting the creditor's claim to the bankruptcy claims process. If the decision is made to litigate outside the bankruptcy claims process, counsel must seek permission from the bankruptcy court by filing a motion for relief from the automatic stay to continue litigating in a non-bankruptcy forum.

Also, invoking the jurisdiction of the bankruptcy court by filing a Proof of Claim may be undesirable when, for example, your client is a foreign entity against which the debtor may have significant claims. Depending upon your client's country of organization and the amount of its claim, it may be more advantageous not to pursue the claim against the bankruptcy estate and to force the debtor to pursue its claim in your client's home jurisdiction to obtain satisfaction. In many cases, the debtor may not find it cost-effective to do so.

FILING THE PROOF OF CLAIM • Upon receiving notice of the bankruptcy case, you should immediately determine and calendar the applicable bar date. Before the applicable bar date, the creditor must prepare and file its Proof of Claim using the Official Form. Fed. R.

Bankr. P. 3001(a). The Official Form may have been mailed to the creditor together with or on the back of the notice advising the creditor of the commencement of the debtor's bankruptcy case or may be downloaded from the web sites of many bankruptcy courts or from http://www.uscourts.gov/bkforms/index.html.

Evidentiary Effect

A properly filed claim has evidentiary effect, so the Proof of Claim should be carefully prepared. For example, if the claim is based on a document, such as a contract, purchase order, or invoice, the document should be attached to the Proof of Claim form. *See* Fed. R. Bankr. P. 3001(f); Fed. R. Bankr. P. 3001(c).

The Proof of Claim should be sent to the clerk of the court in which the debtor's bankruptcy case is pending, together with a copy and self-addressed stamped envelope, for the creditor to receive a file-stamped copy of the claim for its records. *See* Fed. R. Bankr. P. 5005(a). If the creditor receives a Proof of Claim form together with a notice of the commencement of the bankruptcy case, read the claim form and the notice carefully. Either may specify that the Proof of Claim be sent to a third party, usually a "claims agent" appointed in the bankruptcy case for the specific purpose of handling and managing claims. Even if Proofs of Claim are to be forwarded to a claims agent, it is still a good practice to send the claim to the clerk as well. The creditor or its attorney should consult any local rules of court that may impose additional requirements on the filing of Proofs of Claim.

HOW TO INCREASE THE LIKELIHOOD OF PAYMENT • When faced with a customer's, vendor's, or other business contracting party's bankruptcy case, your client may have more options than simply filing a Proof of Claim. Your client may be able to increase the likelihood that the amount it is owed, or at least a greater percentage of it, will be repaid by the debtor in bankruptcy by either determining that the claim is entitled to elevated status under the Bankruptcy Code's claim repayment priority scheme or by pursuing other remedies.

Asserting A Secured Claim, Administrative Expense, Or Priority Claim

The Bankruptcy Code prescribes an order of payment that contemplates different priorities for different types of claims. Secured claims, administrative expenses, and priority claims all enjoy higher payment priority than the garden-variety general unsecured claim. Unfortunately, most ordinary trade claims arising from customer, vendor, or simple contractual relationships give rise to only general unsecured claims.

Secured Claims

First, creditors holding valid liens on the debtor's property—the secured creditors—are repaid first from the collateral securing their liens. *See* 11 U.S.C. §§506, 724, 1129. A creditor seeking to assert a secured claim by filing a Proof of Claim should attach to its Proof of Claim evidence that it has perfected its security interest in the debtor's property. Fed. R. Bankr. P. 3001(d).

Administrative Expenses

With respect to unsecured liabilities, the highest priority is afforded to holders of "administrative expenses." *See* 11 U.S.C. §§503(b), 507(a)(1). Unlike other unsecured claims, an administrative expense arises after a bankruptcy case is filed, not before. Administrative expenses include "the actual, necessary costs and expenses of preserving the [bankruptcy] estate, in-

cluding wages, salaries, or commissions for services rendered after the commencement of the case." 11 U.S.C. §503(b)(1)(A).

Getting Approval

In general, to obtain bankruptcy court approval of an administrative expense, the claimant must demonstrate that:

- The expense arose from a transaction with the debtor in bankruptcy (as opposed to the debtor before it filed its bankruptcy case) or, alternatively, that the claimant gave consideration to the debtor after it commenced its bankruptcy case; and
- The debt asserted to be an administrative expense "directly and substantially benefited the estate."

Employee Transfer Corp. v. Grigsby (In re White Motor Corp.), 831 F.2d 106, 110 (6th Cir. 1987). Note that the services or transaction giving rise to the administrative expense claim must have been provided to the debtor pursuant to a post-petition transaction (i.e., an event occurring after the debtor has filed its bankruptcy petition) and the benefit to the debtor must have been realized after the bankruptcy case was filed. It is not sufficient that payment becomes due after the petition date if the transaction was entered into pre-petition. *See* 4 Alan N. Resnick, Henry J. Somer, & Lawrence King, eds., *Collier on Bankruptcy* ¶[503.06[3][a], at 503-26 (Matthew Bender, 15th ed. 2005) ("Collier").

Courts have also recognized that "considerations of fundamental fairness and logic required the allowance of a claim of administrative priority for damages resulting from the postpetition negligence" of a debtor in possession or trustee. Collier, ¶[503.06 [3][c], at 503-28 (*Reading Co. v. Brown*, 391 U.S. 471, 483 (1968)). Thus, a creditor whose claim arises from a debtor's post-petition tort may assert an administrative expense.

Creditors seeking to assert administrative expenses against the debtor's bankruptcy estate should be aware that the allowance of administrative expenses is disfavored, and the criteria described above are strictly construed. *See Teamsters Ind. Sec. Fund. v. World Sales, Inc. (In re World Sales, Inc.)*, 183 B.R. 872, 875 (B.A.P. 9th Cir. 1995); *In re Cardinal Industries, Inc.,* 151 B.R. 833, 836-37 (Bankr. S.D. Ohio 1992). Accordingly, creditors should consult with their counsel to determine whether any or all of the amounts owed to them by the debtor arose post-petition and may give rise to administrative expense status. Moreover, an administrative expense may not be asserted properly simply by filing a Proof of Claim. The creditor also should consult with counsel regarding the preparation, filing, and prosecution of a request for payment of an administrative expense. *See* 11 U.S.C. §1123(b)(4).

Priority Claims

The Bankruptcy Code enumerates other categories of unsecured claims that have priority over general unsecured claims. They include:

- Certain claims of wage, salary, or commissions earners arising within 90 days of the petition date (up to a maximum of $4,925). Wage-related claims of up to $10,000 arising within 180 days of the petition date are given priority in cases commenced on or after April 20, 2005, pursuant to BAPCPA. For cases commenced prior to April 20, 2005, priority is given to wage-related claims arising within only 90 days of the petition date up to a maximum amount of $4,925;
- Claims arising from contributions to an employee benefit plan;
- Certain grain producer claims;
- Claims arising from certain consumer deposits;
- Spousal or child support claims;
- Specific types of tax claims; and

• Claims arising from certain federal depository obligations.

See 11 U.S.C. §§507(a)(2) – (9). The Official Proof of Claim Form contains checkboxes in which a claimant may indicate that it is asserting a priority claim.

Reclamation Demands

Businesses engaged in the sale of goods are likely familiar with their rights of reclamation against insolvent buyers of their goods, which permits sellers to demand the return of their goods if such demand is made in a reasonable time. Specifically, section 2-702 of the Uniform Commercial Code states, in relevant part:

"(2) If the seller discovers that the buyer has received goods on credit while insolvent, the seller may reclaim the goods upon demand made within a reasonable time after the buyer's receipt of the goods. Except as provided in this subsection, the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay. (3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course of business or other good-faith purchaser for value under section 2-403. Successful reclamation of goods excludes all other remedies with respect to them."

U.C.C. §2-702. Once a buyer of goods has filed a bankruptcy case, the seller's reclamation rights are qualified by section 546(c) of the Bankruptcy Code, which provides:

"(1) such a seller may not reclaim any such goods unless such seller demands in writing reclamation of such goods—

(A) before 10 days after receipt of such goods by the debtor, or

(B) if such 10-day period expires after the commencement of the case, before 20 days after receipt of such goods by the debtor; and

(2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court—

(A) grants the claim of such a seller priority as a claim of a kind specified in §503 (b) of this title, or

(B) secures such claim by a lien."

11 U.S.C. §546(c). Thus, the Bankruptcy Code extends the deadline by which reclamation demands must be made by an additional 10 days if the usual 10-day reclamation demand deadline imposed by U.C.C. §2-702 expires after the commencement of the debtor's bankruptcy case and, if a valid reclamation claim is denied, provides that the reclamation claimant receive either an administrative expense or lien on property. Keep in mind, however, that the reclamation claim must be valid under U.C.C. §2-702 and not subject to the exceptions of that provision in order to receive the treatment specified in section 546(c). For example, the reclamation claim will fail if the goods are subject to the superior interests of a lienholder in the debtor's inventory. *See* U.C.C. §2-702(3).

Pursuant to BAPCPA, section 546(c) of the Bankruptcy Code is amended, effective in cases filed on or after October 17, 2005, to extend the reclamation period from 20 days to 45 days before the commencement of the bankruptcy case. Under the new law, a trade creditor may reclaim goods sold to an insolvent debtor in the ordinary course of business so long as the creditor makes a written reclamation demand within 45 days of receipt of goods by the debtor (but within 20 days after the commencement of the debtor's bankruptcy case). Also, under BAPCPA, unpaid goods sold to the debtor in the ordinary course of business that are received by the debtor within the 20 days before the commencement of the bankruptcy case give rise to an administrative expense, regardless of whether a reclamation claim is made on account of such goods. New section 503(b)(9) of the

Bankruptcy Code awards an administrative expense to "the value of any goods received by the debtor within 20 days before the commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such business." 11 U.S.C. §503(b)(9) (effective October 17, 2005).

"Critical Vendor" Status

Upon the commencement of its bankruptcy case, a debtor is prohibited from making payments on account of pre-petition debts. After all, the satisfaction of such debts is the focus of its bankruptcy case. In a chapter 11 bankruptcy case, the payment of such claims must await the judicial approval (called "confirmation") and implementation of a chapter 11 plan of reorganization. (Although chapter 11 proceedings are colloquially known as "reorganizations," a chapter 11 plan may be utilized for the orderly liquidation of a debtor's assets as well. *See* 11 U.S.C. §1123(b)(4).) The plan is essentially a court-approved modification of the relationships between the debtor, its creditors, and owners by providing for the treatment of "claims" and ownership "interests." Plans may provide for the treatment of creditors and interest holders using a variety of mechanisms, such as payments from the debtor's continuing business operations, the issuance of shares, the distribution of litigation proceeds or payments from proceeds of asset sales. Depending on the terms of the debtor's reorganization plan, a creditor may receive any amount between nothing and 100 percent on account of its pre-petition claim.

Criteria

Certain creditors may be unwilling or unable to wait until confirmation of a plan before they receive payment on account of their claims. Typically, neither impatience nor financial hardship constitutes good reasons for a court to consider allowing the premature payment of certain claims. However, courts will allow the debtor to pay the creditor's claim in full and outside of a plan pursuant to the court's general equitable powers and a judicially created "necessity of payment" doctrine when:

- The creditor is a single-source provider of a good or service critical to the debtor's business;
- The creditor is not bound by a contract to continue to provide the critical good or service to the debtor;
- The debtor is unable to procure an alternate source of such critical good or service;
- The creditor will and can refuse to continue to provide the needed good or service unless its pre-petition claim is paid in full; and
- The creditor's refusal to perform would result in the destruction of the debtor's business.

However, not all courts permit this type of relief, which is clearly extraordinary and, even within the jurisdictions that do authorize payments on account of pre-petition claims, it is extremely difficult to meet all the criteria for "critical vendor" status.

Serving On A Creditors Committee

Soon after the commencement of a chapter 11 case, the Office of the United States Trustee— an arm of the United States Department of Justice responsible for overseeing the administration of bankruptcy cases—will solicit the creditors holding the 20 largest unsecured claims for membership on the Official Committee of Unsecured Creditors. *See* 11 U.S.C. §1102. Also, under BAPCPA, the bankruptcy court may order the United States Trustee to include a "small business concern" (as defined in the Small Business Act) on a creditors committee if the court determines that the creditors' claims against the debtor are disproportionately large when compared to its annual gross revenues. *See* 11 U.S.C. §1102(a)(4) (effective October 17, 2005).

The committee is a fiduciary for all unsecured creditors, represents their interests, and may employ counsel, accountants, and other professionals to carry out its duties. *See* 11 U.S.C. §1103. Because the committee's professionals are paid by the debtor's bankruptcy estate, participation in the committee is a cost-effective means of monitoring the case and advancing the interests of all similarly situated unsecured claimants. *See* 11 U.S.C. §328(a). However, committee membership can be time-consuming and the creditor may be faced with difficult situations in which its interests compete with those of the unsecured creditor body to which it owes a fiduciary duty. Also, under BAPCPA, individual creditors are given mandatory access to certain information from creditors committees, perhaps obviating many of the benefits of serving on such committees. *See* new Bankruptcy Code section 1102(b)(3).

Nondischargeability Actions

Individual debtors, and corporate debtors undergoing reorganization (as opposed to liquidation), may obtain a discharge from the bankruptcy court. A discharge is an injunction forever barring any party from going after the debtor on account of all claims treated in the bankruptcy case.

If the debtor is an individual, the Bankruptcy Code will except from discharge certain debts or refuse to enter a discharge for the debtor when the debtor engages in certain bad acts. For example, the court will except from discharge debts:

- Incurred through fraud or false representations;
- Not listed by the debtor in its bankruptcy schedules;
- Arising from fraud or defalcation while the debtor was acting in a fiduciary capacity;
- Relating to child or spousal support; or
- Arising from willful and malicious injury.

See 11 U.S.C. §523(a). Additionally, the court will not enter a discharge order or revoke a discharge order as to all debts in cases when the debtor, among other acts:

- With the intent to hinder, delay, or defraud a creditor or bankruptcy trustee, transfers, removes, destroys, or conceals property, falsifies or fails to keep books and records relating to the debtor's transactions and financial condition;
- Makes a false oath;
- Gives or receives a bribe;
- Withholds documents relating to its property or financial affairs; or
- Fails to explain the loss of assets.

See 11 U.S.C. §727.

CONCLUSION • Upon learning that a customer or vendor has commenced a bankruptcy proceeding, many businesses automatically file a Proof of Claim form in the entity's bankruptcy case in the hope that some fraction of the debt may be paid at some point in the distant future. The claim is often forgotten—even when a sizeable amount is owed and the debt owed by the entity in bankruptcy is written off. You should give careful thought to whether to file a Proof of Claim and whether, in addition to filing a Proof of Claim, you can pursue additional remedies that may result in a greater recovery for your client.

PRACTICE CHECKLIST FOR
Improving The Odds Of Repayment In Bankruptcy

Filing a Proof of Claim is an essential step in getting paid from the bankruptcy estate, but it should never be done without taking a good long look at the facts.

• Calendar the bar date for filing proofs of claim. Check on any notice received from the court or the debtor that indicates the bar date.

• If any part of the amount owed by the debtor arises after the bankruptcy petition date, a "Request for Payment of Administrative Expense" should be prepared and filed by bankruptcy counsel.

• If any part of the amount owed by the debtor arises before the bankruptcy petition date, and is the subject of pending litigation:

__ Consult with litigation and bankruptcy counsel regarding the effect of submitting to the bankruptcy claims process and waiving the right to a jury trial upon filing a Proof of Claim;

__ Additionally, if the creditor is a foreign entity against which the debtor may assert substantial counterclaims, consult with bankruptcy and litigation counsel regarding strategies for limiting exposure to the debtor's counterclaims before filing a Proof of Claim.

• If bankruptcy and litigation counsel determine that refraining from filing a Proof of Claim would have no litigation benefit, prepare the Proof of Claim form:

__ If the claim is based on any documentation, attach documents to the Proof of Claim;

__ If the claim is secured by a lien on the debtor's property, indicate that on the face of the Proof of Claim form and attach proof of perfection of the lien to the Proof of Claim;

__ If the claim falls within one of the priority claim categories set forth in sections 507(a)(2) – (9) of the Bankruptcy Code, indicate which one in the appropriate check box on the Proof of Claim form;

__ Check the Proof of Claim form, any notice of the commencement of the bankruptcy case, and the bankruptcy court's web site for information regarding where to file the completed Proof of Claim and on whom it should be served. If no special instructions are provided, file it with the Clerk of the Court for the bankruptcy court in which the debtor's case is pending (including an extra copy and self-addressed stamped envelope to receive back a file-stamped copy); and

__ File the Proof of Claim before the bar date.

• Has the creditor recently sent goods to the debtor? If "yes," were the goods received by the debtor within the period specified in U.C.C. section 2-702 as extended by section 546(c) of the Bankruptcy Code? (Note: Use time periods in pre-BAPCPA version of section 546(c) of the Bankruptcy Code if bankruptcy case commenced prior to October 17, 2005; if after, use extended time periods in new version of 546(c)):

__ If "yes," send reclamation demand;

__ If "yes" and goods were received by the debtor within 20 days of the commencement of the bankruptcy case, consult with bankruptcy counsel regarding the filing of a Request for Payment of Administrative Expense.

• Does the creditor supply a critical service or product to the debtor? If "yes," is the creditor required to continue to provide such critical service or product under the terms of a contract?

__ If "no," consult with bankruptcy counsel regarding the assertion of "critical vendor" status in the debtor's bankruptcy case, requiring that the creditor's debt be paid in exchange for agreement to continue to do business with the debtor.

• Has the creditor received any correspondence from the Office of the United States Trustee regarding the formation of the Official Committee of Unsecured Creditors?

__ If "yes," consider and discuss with bankruptcy counsel creditor's participation in the bankruptcy case as a member of the Committee;

__ If "no," is the creditor a "small business concern" whose claim against the debtor is disproportionately large compared to annual gross revenues, and creditor wants to participate as a member of the Committee? If so, consult with bankruptcy counsel regarding petitioning the court to include creditor as a Committee member.

• Is the debtor an individual? If "yes," review sections 523 and 727 of the Bankruptcy Code to determine whether the debtor's conduct falls within any of the enumerated categories in those provisions. If "yes," consider filing a nondischargeability action or a request that the debtor not receive a discharge.