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BANKRUPTCY FOR CONTRACT LAWYERS: A PRIMER

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Introduction. Lawyers working in Article 2 and Article 2A of the Uniform Commercial Code must posses a passing knowledge, if not a detailed understanding, of the federal bankruptcy code [11 U.S.C. § 101 *et seq.*] in order to competently negotiate and enforce contracts for the sale or leasing of goods. Since the adoption of the Bankruptcy Code in 1979, the bankruptcy courts have essentially functioned as the commercial court of the United States, and regularly interpret not only federal bankruptcy law, but also applicable state law, especially as to personal property the law of sales [UCC Article 2], leases [UCC Article 2A], and secured transactions [UCC Article 9].

Bankruptcy law is federal law; Article I, Section 8 of the United States Constitution specifically prohibits the states from enacting any laws regarding bankruptcy. The drafters of the Constitution likely included such a provision for two reasons: first, the concept of debt relief through bankruptcy was so ingrained into our Judeo-Christian culture as to have achieved the status of a fundamental right which was not to be impaired by an individual state; second, uniformity of the processes and consequences of economic failure facilitates the federal regulation of interstate commerce.

The bankruptcy courts are courts of equity. Distilled to its essence, the bankruptcy process is determining how best to carve up a 12-pound turkey among 50 or more guests at the Thanksgiving feast. The Bankruptcy Code often mandates that decisions of the bankruptcy judge be based upon what is “fair and equitable” [*See, e.g.*, 11 U.S.C. §1129(b)], but it is clear that most, if not all of the guests [creditors] will depart hungry from the host’s [debtor’s] table.

> *Practice Tip:* When the law is not in your favor [or you can’t remember the applicable law] argue that fairness and equity compel the result your client desires.

Organization of the Bankruptcy Code. The bankruptcy code is organized into chapters, similar to the Articles in the UCC. With one exception, the chapters are all odd numbers. The bankruptcy code can be visualized as a tree, with Chapters 1, 3 and 5 forming the trunk, and Chapters 7, 9, 11, 12 and 13 forming the crown. The administrative provisions of Chapters 1, 3 and 5 apply for the most part without significant variance to each of the operative Chapters 7, 9, 11, 12 and 13. Chapter 1 contains mostly definitions, as well as setting forth the debtor’s eligibility for the various types of bankruptcy. Chapter 3 addresses matters regarding the administration of the case, while Chapter 5 defines the relationships between and among the debtor, the creditors and the estate.

Definitions. Like any specialized area of the law, bankruptcy utilizes certain terms of art, and the

meaning of some of these terms is different not only from plain language but also, (somewhat confusingly) from the UCC. A recitation of all the terms is well beyond the scope of this primer, but presentation of certain basics will be of benefit. The natural person or entity which is availing itself of bankruptcy relief is the "debtor" [the word "bankrupt" – thought to be too pejorative even though political correctness had not yet come of age – was banished by the 1978 Bankruptcy Code]. Also replaced in the 1978 Code were Roman numerals for the Chapters; use Arabic or be branded a neophyte. The bankruptcy "case" (not "proceeding"-- also the old terminology) is commenced by the filing of a "petition for relief". Because the rights of the various parties are generally fixed on the date the petition is filed, the Code makes liberal use of the terms "prepetition" and "postpetition". Upon the filing of the petition, the "estate" comes into existence, which means, if you remember your 1st year Property course, bankruptcy practitioners must occasionally wrestle with the concept of a "res", with attributes different from the debtor itself.

Types of Bankruptcy. There are five substantive Chapters, but essentially only two types of bankruptcy cases. The vast majority of cases are liquidation bankruptcies, which are filed under Chapter 7. The other type is a reorganization bankruptcy, which may proceed under Chapter 9, 11, 12, or 13 depending upon the attributes of the debtor.

Chapter 7: Also referred to by non-practitioners as a straight bankruptcy, a Chapter 7 case may be commenced by a natural person, husband and wife, corporation, partnership, LLC or other form of business entity authorized by the state of domicile excepting a trust. All of the assets of the debtor become property of the estate [11 U.S.C. §541], and an independent trustee is appointed to examine such assets, collect and liquidate those which have value, or "equity" to the estate, and make a distribution to creditors of the proceeds, after satisfying the expenses of administration. Natural persons are permitted to claim certain assets "exempt" under applicable laws of their state of domicile [11 U.S.C. §522], and thus unavailable to the trustee for liquidation and distribution to creditors. The best-known exemption, available in various forms in all fifty states, is of the "homestead" or personal residence of the debtor and dependents. Natural persons filing Chapter 7 are entitled to obtain a "discharge" of the majority of their debts [11 U.S.C. §727] which is the driving force behind most of the consumer bankruptcy cases. This discharge allows financially distressed individuals a "fresh start" at rebuilding their net worth and credit. Just as with exemptions, only natural persons may receive a discharge [11 U.S.C. §727(a)(1)], so a corporation or partnership Chapter 7 debtor is simply liquidated and does not continue in business.

Chapter 9: Available only for states and political subdivisions, Chapter 9 cases are not only rare but also unique because a total liquidation and cessation of business is not possible. The most famous recent Chapter 9 reorganization was filed by Orange County following the collapse of its high-risk investment program.

Chapter 11: This reorganization Chapter is available for all types of debtors, but is designed for business operations. It nominally allows the debtor to continue in possession and

management of the assets of the estate without the supervision of a trustee [the "Debtor-in-Possession, or DIP; 11 U.S.C. §1107]. If successfully prosecuted, the Chapter 11 case results in the confirmation by the court of a "plan of reorganization" which normally provides for the repayment of creditors over time from the continuing operation of the business, and provides for a discharge of all pre-confirmation debts, whether the debtor is a natural person or entity [11 U.S.C. §1141]. Creditors may be significantly involved in a Chapter 11 case; at a minimum they are afforded the opportunity to vote on the plan, and under certain circumstances, may obtain the appointment of a Chapter 11 trustee to dispossess the debtor from management of the estate, or file their own plan of reorganization. While the Chapter 11 plan normally would provide for the continuation of the debtor's business, it can alternatively effect an orderly liquidation of the debtor's business. In theory, the opportunity to sell a business as a going-concern in Chapter 11 will yield a higher return for creditors that a auction sale of the pieces in Chapter 7.

Chapter 12: Yet another illustration of the political and emotional power of agriculture in the United States, this Chapter was added to the Bankruptcy Code in 1986 after the widespread loss of family farms (at least anecdotally) during the financial crisis commencing in 1981. Chapter 12 is sort of a hybrid of Chapter 11 and Chapter 13 exclusively for "family farmers" as defined in 11 U.S.C. §101. Due to maximum debt limitations, and the relatively high value of California real estate as contrasted with farmland in the Midwest, the practical applications of Chapter 12 in this state are limited. By a wide margin, the Fresno bankruptcy court receives the most filings; but only about 15-20 cases per year at present. The author filed the first Chapter 12 case in the Oakland bankruptcy court in early 1986 for a cattleman in the Brentwood / Knightsen area; as of late 1999 no other Chapter 12 case had ever been filed in that court.

Chapter 13: Often referred to as a "wage-earners" bankruptcy, Chapter 13 allows natural persons who have regular income and total debt less than a maximum cap to reorganize by making regular payments to a Chapter 13 trustee for the benefit of the creditors. By agreeing to devote postpetition earnings to the repayment of creditors, the Chapter 13 debtor does not lose non-exempt assets as with Chapter 7. Payments under the plan normally extend for a period of three years, but may not extend for longer than five years. In many courts, the Chapter 13 process has become highly routinized, with proscribed forms for the plan and other pleadings, and standard orders which allow the Chapter 13 trustee and its staff to administer cases, including dismissals for plan defaults, without significant judicial involvement. The classic Chapter 13 case is a husband and wife, both wage-earners, who are over-extended on credit cards and facing foreclosure of their personal residence. Due to the routinized nature of most Chapter 13 trustees and courts, this Chapter is not often utilized by small business owners, who may not enjoy monthly earnings sufficiently consistent to be able to fund a fixed monthly payment. Upon successful completion of all payments under the plan, the Chapter 13 debtor receives a discharge [11 U.S.C. §1328].

Petition & Automatic Stay. A bankruptcy case is commenced by the filing of a petition, either voluntary by the debtor [11 U.S.C. §301] or involuntary by one or more creditors [11 U.S.C. §303].

Upon the filing of the petition, the broadest injunction known in American jurisprudence is immediately in place. This "automatic stay" protects both the debtor and the property of the estate, and prohibits the commencement or continuation of virtually any action regarding monetary claims. [11 U.S.C. §362(a)]. It can be likened to an umbrella opened by the debtor which not only keeps the rain from the debtor itself, but also all of those items of its property under the span of the umbrella. The stay not only has the effect of fixing the rights of the various parties as of the filing of the petition, but also replaces the "race to the courthouse" principles of state collection laws with the concept of equitable distribution as embodied in the Bankruptcy Code. It also allows the reorganizing debtor a respite from putting out fires so as to focus on the propriety of continuing ongoing operations. Obtaining the automatic stay itself is often the primary reason a bankruptcy case is filed, certainly in the case of debtors facing imminent foreclosure or other involuntary loss of property. Under certain conditions, creditors may obtain termination or modification of the automatic stay, but a formal motion is required, which allows the bankruptcy court to balance the competing equities of the debtor, the creditor seeking the relief, and other creditors.

> *Practice Tip:* The automatic stay prohibits even telephone calls to the debtor to collect a debt, and its enforceability is not dependent upon notice being given to the affected creditor. Violation of the stay exposes a creditor to actual damages, and punitive damages if wilful.

Schedules & Statements. The petition is accompanied by detailed listings of the debtor's assets and liabilities, called "schedules", and various other documents filed under penalty of perjury, most notably the "statement of financial affairs". These documents allow the court to mail notice of the filing to all creditors, as well as allow the judge, any trustee and interested creditors to understand the case, identify and administer property of the estate, and evaluate creditor claims.

Claims; Priorities. Creditors are only entitled to receive a distribution from the estate if they hold a "claim" [11 U.S.C. §101] which has been or is deemed "allowed" [11 U.S.C. §502]. Claims include not only customary monetary obligations, but also any rights against the debtor which arose prepetition, whether contingent, unliquidated or disputed. It is this broad definition of claim which gives to bankruptcy courts the ability to reorganize entities facing mass tort liability, even from plaintiffs yet unknown [*e.g.* Johns Mansville (asbestosis); A.H. Robbins (Dalcon Shield IUD); a future tobacco producer?].

> *Practice Tip*: In most cases, the timely filing of a proof of claim [11 U.S.C. §501] is essential in representing a creditor. Once the creditor has filed a proof of claim, it will be deemed allowed, unless an objection to allowance is filed. Most Chapter 7 cases, and even some Chapter 13 and Chapter 11 cases end with no distribution to unsecured creditors, but that is little consolation to counsel on the receiving end of a malpractice claim for failure to timely file a proof of claim. It is a simple form, and no filing fee is required.

Whether and how much a given creditor will receive depends upon the priority of its claim. A claim properly secured [generally under state law] by property of the estate has absolute priority, *as to that*

property only, over unsecured claims, or secured claims of junior priority. It is not surprising that for most debtors, the liquidation value of its property is less than its claims, and also, that most, if not all of its property with significant value has already been encumbered. Dividends to unsecured creditors presuppose either unencumbered assets, or liquidation proceeds in excess of secured claims. Certain unsecured claims are given a statutory priority of distribution. [11 U.S.C. §507]. The first priority is for the administrative expenses [11 U.S.C. §503] of the bankruptcy process itself , and thereafter available funds are distributed to the holders, if any, of eight additional priority categories, the most significant of which are certain wage and benefit claims of employees of the debtor, and certain tax claims. Each category of priority claims must be satisfied in full before funds are available for distribution to the next level. If funds remain after satisfaction of the priority claims, general unsecured creditors [a.k.a. "the great unwashed"] receive a pro-rata dividend. A secured creditor whose collateral is insufficient to fully cover its claim is undersecured, and essentially holds a bifurcated claim: secured to the extent of the value of the collateral; unsecured for the difference. Equity interests in liquidation cases receive no dividend until and unless all creditor claims are satisfied in full.

Dischargeability of Debt. Not all debts are dischargeable. Spousal support, child support, taxes incurred within three years prior to filing, and guaranteed student loans are examples of debts which are statutorily non-dischargeable by a individual debtor [11 U.S.C. §523]. By timely filing a lawsuit [referred to as an "adversary proceeding"], a creditor may seek a determination that its particular debt owed by an individual debtor is non-dischargeable if based upon fraud [11 U.S.C. §5523(a)(2)], a defalcation in fiduciary duty [11 U.S.C. §523(a)(4)], or a wilful and malicious injury [11 U.S.C. §523(a)(6)]. The burden of proof of non-dischargeability is on the creditor, and successful prosecution is difficult, as the granting of a discharge in furtherance of a debtor's "fresh start" is the fundamental purpose of bankruptcy. Chapter 13 debtors successfully completing their plan payments are granted a "super-discharge" from all but a few of the statutorily non-dischargeable debts found in Bankruptcy Code §523 [11 U.S.C. §1328].

Executory Contracts & Unexpired Leases. Bankruptcy Code §365 is of special import to lawyers working in UCC Article 2 and UCC Article 2A. This section affords the bankruptcy trustee or debtor in possession the ability to cure prepetition defaults in an executory contract [interpreted to mean that performance, other than a mere duty to pay, is still due by both parties] or an unexpired lease, notwithstanding provisions in such contract or lease which would otherwise justify termination or the non-debtor party withholding its performance. Not only that, but the bankruptcy estate is given the opportunity to assign its interest in the contract or lease to a completely unrelated third party, notwithstanding an otherwise enforceable provision prohibiting assignment. Finally, Bankruptcy Code §365 also allows the trustee or debtor in possession to "reject" [breach] an executory contract or unexpired lease during the bankruptcy case, and treat the claim of the non-debtor party as a prepetition unsecured claim, subject to compromise and discharge.

Trustee's Avoiding Powers. Lawyers working in UCC Article 2 must also be wary of the exercise

by the trustee or debtor in possession of what are known as the "avoiding powers". This group of Bankruptcy Code sections is designed to facilitate an equitable distribution of the estate among creditors, but can have harsh results to a particular creditor.

Strong Arm Clause. The trustee is imbued with the power of a hypothetical creditor under state law which obtains a judgment lien against all property of the estate immediately prepetition. With this power, the trustee can "strong arm" the claim of an unperfected secured creditor [11 U.S.C. §544(a)].

Practice Tip: The strong arm powers are subject to state law delayed perfection rights, including the 10-day right of reclamation found in UCC 2-702, but the time periods are not extended as a result of the filing of the bankruptcy petition. Act swiftly and issue written demands upon debtor and its counsel [11 U.S.C. §546].

Fraudulent Transfers. The trustee is also empowered to recover prepetition fraudulent transfers by the debtor under not only the applicable state law [11 U.S.C. §544(b)], but also a specific bankruptcy statute [11 U.S.C. §548]. The bankruptcy statute has a one-year reach back; state law generally has a three-year as well as a four-year reach back if the Uniform Fraudulent Conveyances Act has been adopted by the applicable state.

Preferences. The trustee is also empowered to recover certain payments or other transfers made within 90 days prepetition as to general creditors, and within one year prepetition as to "insiders" of the debtor [11 U.S.C. §547]. The recovery of preferences is designed to discourage the "race to the courthouse" which often precipitates a debtor's slide into bankruptcy, and ameliorate the effect of a particularly chummy creditor or a particularly persistent creditor being favored by a debtor at the expense of others. The preference statute is especially complex, and cases interpreting it are even more so, but as a general rule, payments made in the ordinary course of business on non-delinquent debts are not preferential.