CHAPTER 1

BANKRUPTCY FROM YOUR CLIENT'S PERSPECTIVE

For the nonspecialist in bankruptcy, discovering that your client finds itself on the other end of a relationship influenced by a participant that has sought relief under the Bankruptcy Code could be daunting. As one will soon discover, bankruptcy law has both a substantive and procedural dimension. The law borrows heavily from applicable non-bankruptcy law; thus, it resembles more an open code than its does a closed code, such as Article 3 of the Uniform Commercial Code. However, when bankruptcy law borrows from applicable non-bankruptcy law, it does so on its terms and in a manner consistent with bankruptcy law and policy. Of course, hidden throughout the Bankruptcy Code are traps for the unwary; just as you become comfortable traversing the interconnectedness of bankruptcy law and, for example, state real property law, a provision of the Bankruptcy Code pulls the carpet out from under you. That is where this book comes in.

We did not choose to write yet another book surveying the bankruptcy waterfront. There are several small books that already provide that service. Instead, we have endeavored to provide you with a look at bankruptcy from the perspective of the client who is dealing with a customer, borrower, etc., in bankruptcy. The idea is that a book that structures itself in a way in which a non-bankruptcy specialist may

approach a bankruptcy issue may ultimately be more useful than a traditional approach. In the remainder of this chapter, we discuss a number of typical relationships that may arise. Within each of these relationships, we identify recurring issues and bankruptcy milestones. The remainder of this book provides the substantive and procedural flesh to those milestones and issues we have identified in an appropriate context.

1.1 SINGLE-ASSET REAL ESTATE (UNDEVELOPED LAND)

For many, the scourge of bankruptcy is the single-asset real estate case where the focus is on a parcel or several parcels of undeveloped land. Much ink has been spilled on how irregular single-asset real estate cases are, and how difficult it is to fit them in the overall themes embodied in the Bankruptcy Code. The base case is a borrower who owes money to a lender. The funds were borrowed to acquire the property. The borrower has secured repayment by granting a lien in the undeveloped land. The borrower seeks to either develop the land or flip it as the market goes up. It does not. The value of the land falls precipitously. Soon, the borrower finds that it has no equity in the property; that is, the debt on the property exceeds its value. We say that the property is *under water* or *upside down*. Usually, aside from the lender, there are very few (if any) other creditors. Normally, any additional creditors possess relatively small, unsecured claims. There may be a taxing authority owed some tax—such as a county that is owed an ad valorem property tax—but all parties expect that the tax will be paid. Typically, the insiders of the borrower have guaranteed the debt. The loan is in default. The lender has posted the property for foreclosure (or is close to judgment in a judicial foreclosure state). The facts reek of a two-party dispute: not the type of case that you would generally have in mind when considering the bankruptcy process.

More often, you would see a case like this from the perspective of lender's counsel. On behalf of your client, you have already exercised any rights existing under state law, sued on the note and guaranties, and commenced a foreclosure action. As you approach judgment, you are met with a last-ditch effort by the borrower to keep the property and protect against the adverse tax consequences of a foreclosure sale by commencing a chapter 11 case under the Bankruptcy Code. For your client, the plan of attack is rather straightforward. Your client will generally seek relief from the automatic stay under section 362(d) to permit foreclosure. In the interim, you may ask the court at the preliminary hearing to modify the stay to let you send out the appropriate notices and post the property for foreclosure, if the property happens to be in a nonjudicial foreclosure state and your documents give your client a power of sale. If the property is declining in value, you may also seek adequate protection under section 361. Your client may also seek to dismiss the case under an implied duty of good faith in filing a bankruptcy petition. The argument goes that the case was not commenced in good faith. Courts have developed a panoply of factors indicating bad faith. These factors are discussed in a subsequent chapter. Your client may also seek dismissal of the case or conversion of the chapter 11 case to a case under chapter 7 for one of the delineated grounds found in section 1112(b). Your client may also consider the appointment of a chapter 11 trustee to displace the debtor in possession and liquidate the property in an orderly fashion. All along, your client may be pursuing litigation against the insider guarantors who may seek to extend the stay in the underlying debtor's bankruptcy case through an injunction, a tactic often threatened but seldom successful. Finally, your client may actually consider the possibility of the debtor moving forward with some limited breathing room in bankruptcy if your client thinks that the debtor and its insiders may be in a better position in marketing and selling the property. In sum, although your client has a well-equipped arsenal to

launch in a case involving a single-asset real estate debtor whose asset is undeveloped land (and usually interpersonal tensions run very high in these types of cases), once in a while the better course is to allow a short play of the bankruptcy process closely monitored by you on behalf of your client. The rest of this book will provide the legal context to the course we have charted for a relationship like this.

As mentioned, the single-asset real estate debtor with no income-producing property is our base case, but it is not our only case. One can imagine a spectrum of single-asset or near single-asset real estate cases that do house income-producing properties that do look like traditional businesses worthy of a spin at the reorganizational wheel. These cases could include hotels, spas, marinas, apartment complexes, strip malls, and the like. In these cases, often special bankruptcy provisions directed to single-asset real estate cases may be triggered, adding another layer of complexity. These cases also bring with them a range of issues common to most any business bankruptcy, including the authority to use cash collateral, post-petition financing, the treatment of leases and executory contracts, claims adjudication, and access to utilities and post-petition credit. The rest of this book will also provide the legal context to address these issues.

1.2 REAL ESTATE DEVELOPER

If cash is king, then dirt is lord. Real estate runs the economy. Distressed real estate drags down the economy. Nowhere is this more true than in real estate development, be it commercial or residential. These types of bankruptcy cases pose a unique nest of bankruptcy issues. Take, for example, a residential real estate developer. In financing its projections, it may have obtained one or more term loans *and* a revolver from several banks or several bank groups, depending on size of the credit. This debtor may be dealing with various subcontractors, suppliers, construction workers, a sales staff, advertising and marketing agencies, purchasers asserting

warranty claims, regulatory authorities, and taxing authorities. The debtor may also have some properties housed in land banks. Properties may be generating cash flow (income-producing or investment properties) or may be in various stages of construction or development (developmental properties). Your client may be any one of these interested parties.

With a case like this, the bankruptcy signposts differ depending on your client. If your client is a secured lender, then you will generally focus on protecting its secured position. In doing so, you will negotiate with the debtor over the use of your client's cash collateral, implicating sections 363 and 361. Your client is also interested in whether it is entitled to post-petition interest, and if so, at what rate, and whether it is entitled to recover your fees if the documents so permit. These issues are resolved by reference to sections 506(a) and (b) and the facts and circumstances of your case. Your client may decide to roll over its debt into a tidy post-petition lending facility, implicating section 364. If a new lender is coming into the picture to provide post-petition financing, then your client may seek to protect its relative priority position or insist that it be taken out by the new lender. Although your client may have the right to seek relief from the automatic stay under section 362, that is most likely not the right thing to do, at least not early in the case. If the value of the bankruptcy estate is such that the secured creditors will not be made whole, then you should expect the unsecured creditors, usually through their official committee, to scrutinize closely your client's relationship with the debtor and possibly seek to assert an avoidance action against your client, usually in the nature of a constructively fraudulent transfer action.

If you represent an unsecured creditor with a relatively large claim, your client's first bankruptcy issue may be whether to accept the appointment by the U.S. trustee to become a member of the Official Committee of Unsecured Creditors. The committee is the counterpart to the debtor in possession, is influential in the chapter 11 process, and is privy to

virtually all relevant information. However, the committee acts as a collective body and owes a fiduciary duty to the bankruptcy estate. As counsel to a member, you will work closely with the committee's own counsel in mapping out a strategy in the chapter 11 process, investigate pre-petition transfers, and closely scrutinize all insider transactions, among other things. As counsel to your client, you will also act to protect its best interests, timely file proofs of claim, review other claims that have been filed that rank your clients, and ensure that your client has the opportunity to be heard when its interests are at issue.

If you represent a relatively small unsecured creditor, your client may determine it is not in its best interests to participate actively in the case. It may ask you to file a proof of claim and loosely monitor the case to ensure that nothing unexpected happens to its interests. You will learn that this request is fraught with risk for you and your client. Although your client should usually file a proof of claim under section 501, it does not follow that it should always do so, especially if doing so waives certain jurisdictional protections, and the projected distribution is nominal. Moreover, loosely monitoring anything is difficult. Generally, you are either in the case or you are not. If you are in the case, you will file a notice of appearance and request for service of all papers filed with the court, including any copies of the disclosure statement or plan of reorganization under Bankruptcy Rule 2002. Once in, you must be diligent on behalf of your client and regularly monitor the docket.

Thus, even in a simple real estate development bankruptcy case, one may confront a myriad of issues and a multitude of parties. The rest of this book will provide the legal context to handle these issues and to anticipate the motivation of the parties involved.

1.3 RETAIL (MOM-AND-POP) LLC

Seventy percent of our economy is driven by consumer demand. One extremely important area where consumers

interface with business is the retail sector. The retail sector ranges from very large national department stores (so-called "category killers") to very small ones to a few store operations. This section is about the latter.

Small retailers are the heart and soul of the retail sector. They provide a disproportionate number of jobs and keep a number of vendors and service providers in business. The range of relationships includes a lender who provides both a term loan (for capital expenditures, etc.) and a "revolver" or line of credit (for financing inventory purchases, etc.) secured by various categories of collateral, trade creditors that provide goods and services on open account according to credit terms, the landlord that provides the premises, transportation and shipping providers, advertising, and taxes. The secured lenders confront substantially the same issues as those previously identified in discussions above. Trade creditors are generally unsecured creditors who may possess a general unsecured claim against the estate or a possible administrative expense grounded on reclamation rights or the new priority under section 503(b)(9). Trade creditors often make up the bulk of the seats on the official committee of unsecured creditors. They are also often the recipients of preferential transfers, although they may have certain defenses that may limit or even eliminate any potential preference exposure. Landlords also possess claims against the estate. The extent and priority of those lease claims depend, in large part, on how the lease is treated in bankruptcy. This is a complex issue that is discussed in a later chapter. Transportation and shipping creditors are generally unsecured creditors but must be kept relatively happy, for they provide the essential lifeline between goods and sales. Advertising and insurance providers also possess unsecured claims, although the insurance company may have been prepaid and may owe the estate any unused prepayment if the contract is canceled. Taxes may be in arrears, including certain trust fund taxes like federal payroll taxes. This may expose insiders who are responsible persons under the Internal

Revenue Code to personal liability. All of these issues are further discussed throughout the book.

1.4 NATIONAL RETAILER

National retailers pose many of the same issues we just covered in the small retail case, just on a grander scale. In addition to the claims identified above, national retailers may also have international relationships, often purchasing through brokers, factors who are financing receivables by buying or factoring accounts, debt held by bondholders (including public debt), potentially thousands of vendors representing a broad array of goods and services, an impressively large number of nonresidential real property leases, and various classes of equity. Committee composition is important in these cases, especially where the trade creditors are squaring off against the holders of bond debt. In these cases, the going-concern value of the company is of particular importance, as are the relative rights, priorities, and obligations of the parties in interest. If your client finds itself in one of these bankruptcy cases, then, in addition to the issues we have previously discussed concerning creditors, you should add a careful consideration of section 363 sales of assets, including substantially all the assets of the debtor, disclosure-statement issues regarding adequate disclosure, plan-confirmation issues, potential cram down[1] absent unanimous consent by classes, and attempts by old equity to retain an interest in the reorganized debtor under the new value exception to the absolute priority rule.

1.5 MANUFACTURER

Manufacturers are part of the bread and butter of bankruptcy practice. These types of debtors bring issues substantially similar to national retailers in regard to secured creditors and general unsecured creditors. In these types of cases, you regularly see section 503(b)(9) claimants, reclamation

1. Cram down is the ability of a plan proponent to confirm a plan over the objection of a dissenting class of creditors, assuming certain requirements are met. *See* Section 11.9, *infra.*

claimants, and so-called critical vendor lists that seek to elevate what is a pre-petition unsecured claim to an administrative expense priority. In these cases, you may also represent a union that has a collective bargaining agreement with the debtor manufacturer. Moreover, these cases also regularly expose an underfunded pension, often making the Pension Benefits Guaranty Corporation (PBGC) a big player in the bankruptcy case.

Like the national retailer counterpart, manufacturer bankruptcy cases pose interesting disclosure and plan confirmation issues. The Official Committee is generally very active. Parties often resort to section 363 to sell all or substantially all of the assets without relying on the plan process. Debtors and the committee also often rely on a liquidating or litigation trust to pursue various actions for the benefit of the unsecured creditors once the sales of assets under section 363 have been approved.

1.6 PROFESSIONAL FIRM

Law firms and medical practices are not immune from financial distress. These practices are often in the form of some type of limited liability entity vehicle, such as a limited liability company (LLC). The filing of a bankruptcy petition by an LLC poses its own unique bankruptcy issues regarding eligibility, scope of the estate, governance, and claims issues. In these cases, creditors possessing claims face many of the same challenges as discussed above. However, some recurring issues unique to professional firms include insider transfers that must be scrutinized, existence of trust accounts that should not be included as property of the estate, and invasion or commingling of such trust accounts, thus making these funds property of the estate. These issues will be discussed in other chapters of this book

1.7 YOUR FIRM

Your firm may find itself a creditor in a bankruptcy case for unpaid billable work or may find itself a defendant in a pref-

erence action brought by one of its clients. In these circumstances, it is imperative that you develop all of the facts and circumstances so as to have the information necessary to make a timely and informed decision on how best to proceed. In most instances, you will file a proof of claim; however, in some important instances you may refrain, especially if the projected distribution is nominal and the likelihood of drawing a defense based on malpractice is great. It is also important not to make any demand for payment—informal or formal, express or implied, verbal or nonverbal. Any demand may constitute a violation of the automatic stay and may expose your firm to sanctions.

It is not unusual to possess a retainer to secure payment by your client. Once your client files a bankruptcy petition, you may no longer draw on the retainer to cover any outstanding pre-petition debt. However, you may have a right to setoff and a secured claim to the extent of the retainer funds pursuant to section 506(a). You should return any retainer in excess of amounts billed but unpaid. This overage is property of the estate under section 541 and should be returned in an expeditious fashion to avoid a stay violation under section 362(a)(3).

A recurring issue occurs where your client files for bankruptcy relief and then demands that your firm turn over your files and work product without paying for services rendered in full. This particular issue will require a more detailed response.

A law firm or an accounting firm that had been engaged by a client who later files for relief under the Bankruptcy Code may demand the turning over under section 542 of all of the client files and the professional's work product relating to those files for pre-petition professional services. The attorney or accountant may, however, be quite unwilling to comply with this demand unless it is paid on every outstanding account receivable and any accrued but unbilled time charges; depending upon the jurisdiction in which the professional services were rendered, the attorney or accoun-

tant may argue that it holds a charging or retention lien, which is a secured claim, and that it is entitled to be paid in full as a condition for releasing its lien and complying with the demand.

The legislative history of the Bankruptcy Code asserts the proposition that the professional firm must turn over its files to the debtor in possession or to the trustee. There is absolutely no sympathy for the professional firm's insistence upon being paid as a condition for turning over its files to the chapter 11 debtor in possession or to the chapter 7 (or chapter 11) trustee. The policy justification is that these files are likely to be necessary for the orderly administration of the bankruptcy estate, and that policy trumps the rights or interests of the professional firm. To some extent, this is consistent with section 541, which defines property of the debtor or the bankruptcy estate very broadly. Surely the documents or records of the client that have been sent to the professional firm are property of the debtor or of the estate, but it is a stretch to infer that any of the work product of the professional firm is also property of the debtor or of the estate. Section 542(e) governs the protection of the debtor's client-attorney privilege of confidentiality in cases in which turnover of professional files is required. This subsection also extends to the protection of the debtor's client-accountant privilege if that privilege is recognized by the jurisdiction in which the professional services are substantially performed. Subsection 542(e) has been read very liberally by some courts to extend the scope of property of the debtor or of the estate to work product on the rather shaky premise that the work product is prepared for the benefit of the debtor and, therefore, becomes property of the estate. As such, work product is subject to turnover, whether paid for or not.[2]

2. For a comprehensive discussion of all of these issues that disfavor the claims of attorneys, *see In re* Am. Metrocomm Corp., 274 B.R. 641 (Bankr. D. Del. 2002).

Many courts have conceded that whether a professional firm is entitled to claim a charging or a retention lien on the client files and especially on the work product files is governed by applicable state law. In fact, there are several jurisdictions that clearly recognize under their common law decisions or under explicit statute that charging or retention liens are valid and enforceable for professional services by attorneys and, in a lesser number, by accountants. So if the applicable state law recognizes the lien of the professionals, then they may treat their claim for unpaid professional services as a secured claim, and may condition the release and delivery of those files to the debtor or debtor in possession upon payment of reasonable professional compensation and reimbursement of expenses. That request is not likely to be supported by the Official Committee of Unsecured Creditors or by the United States trustee. Those firms that have provided professional services during the pre-petition period in a jurisdiction that does not recognize a retaining lien for law firms or accountants are out of luck, and they must deliver the client files and probably their work product to the debtor in possession or the chapter 7 trustee, subject to the claim of confidential privilege held by the debtor with respect to communications with its former attorney or accountant (assuming the jurisdiction recognizes such a privilege for accounting firms), and further subject to the professional's claim of the work product privilege.

Rather than complicate this brief discussion with the complex issue of the confidential privilege, it is settled law that the debtor in possession succeeds to the debtor's privilege, and a chapter 7 trustee succeeds by operation of law to a corporate debtor's privilege. The law is far less settled when a chapter 7 trustee purports to assert the privilege held by a debtor who is a natural person.

Since, in almost all instances, the enforceability of the lien requires continuous possession of the files, the concept of adequate protection under section 361 would seem not to apply. If the files are to be turned over, possession is lost,

and the lien fails unless the court enters an order purporting to recognize the lien as valid and enforceable notwithstanding the turnover. But even as a secured claim, it makes no practical sense to offer periodic payments for the use of the files by the debtor in possession, or in certain cases the chapter 7 trustee, and it is difficult to conceive of some treatment of the secured claim based upon an indubitable equivalent.

In a majority of the circuits, the professional law or accounting firm may not collect its pre-petition secured or unsecured claim by agreeing to continue performing services for the chapter 11 debtor in possession under a "general retainer." That is because a professional firm cannot be retained by the debtor in possession or by an operating chapter 11 trustee as long as it is not disinterested.[3] Holding a secured or unsecured claim for unpaid pre-petition professional services owed by the estate is per se disqualifying under the very broad definition of a lack of disinterestedness.

Many pragmatic courts have held that if the professional firm unqualifiedly waives its pre-petition claim, that waiver will remove this disqualification. If the claim is substantial and there is a reasonable probability that the chapter 11 estate will be in a position to pay a decent percentage of the unsecured claims, then the firm may agree to waive the claim, but that is quite a risky bet for the great majority of chapter 11 cases. There is a little more latitude for the retention of special counsel with a pre-petition claim for unpaid legal services under section 327(e) to perform specific functions, usually the prosecution of pending actions for which the general counsel for the debtor in possession has no expertise or is unwilling to do personal injury or other work on a contingent-fee basis.

3. *See* section 101(14) for the definition of "disinterested person."