Chapter 11 Bootcamp: What the Credit Team Needs to Know

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Different Bankruptcy Cases – Chapter 11

- Reorganization or Rehabilitation of Business
- Liquidating Chapter 11
  - Often via sale of Debtor's business/assets
  - Retailers in Chapter 11 have frequently conducted going out of business sales
- As a General Rule Debtor's Management Continues
  - Chapter 11 trustee is exception

Key Players in Chapter 11

Debtor / Debtor-in-Possession / "DIP"

- The entity "in bankruptcy"
- A debtor-in-possession maintains control of its business and assets while in bankruptcy, subject to statutory restrictions

United States Trustee

- Unit of the United States Department of Justice
- Independent overseer of bankruptcy cases

Creditors' Committee

- Appointed by the United States Trustee shortly after filing
- Usually 3-7 of the debtor's largest unsecured creditors
- Statutory fiduciary of all of the debtor's unsecured creditors
- Retains its own professionals compensated by the estate

Key Players in Chapter 11 (continued)

DIP Lender

- Lender providing postpetition financing to the debtor typically protected by very broad liens and claims

Chapter 11 Trustee

- Not the same as the United States Trustee
- Appointed by court order under § 1104(a) in extreme cases:
  - Fraud, dishonesty, incompetence, gross mismanagement
  - Or "if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate"

Examiner

- "Trustee light" – appointed to investigate the debtor "as is appropriate," including fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in current or former management
  - Will sometimes lead to appointment of chapter 11 trustee

Voluntary vs. Involuntary Bankruptcy Filing

- Debtor Commences a Voluntary Bankruptcy Case By Filing a Bankruptcy Petition
- Creditors Can Force a Debtor Into Bankruptcy By Filing an Involuntary Bankruptcy Petition and Satisfying the Requirements of Bankruptcy Code Section 303

Involuntary Bankruptcy Petition

- Three or More Petitioning Creditors Have Unsecured Claims
  - Not contingent
  - Not subject to a bona fide dispute as to
    - Liability or
    - Amount
  - Totaling not less than
    - $15,775 for bankruptcy cases filed from 4/1/2016 through 3/31/2019
    - $16,750 for bankruptcy cases filed on and after 4/1/2019
  - Debtor has 12 or more unsecured creditors
- If Debtor Has Fewer than 12 Unsecured Creditors, Excluding, Employees, Insiders, and Transferees of Voidable Transfers (e.g., Preference Claims), Only One Petitioning Creditor With Claim of At Least the Required Statutory Minimum

Involuntary Bankruptcy Petition

- Meaning of Bona Fide Dispute – Courts Are Divided
  - *In re QDOS*, U.S. Bankruptcy Court, Central District of California – 2 of 4 petitioning creditors disqualified based on claims subject to bona fide dispute, one of which was partially disputed, resulting in dismissal of involuntary petition
  - U.S. District Court, Nevada in *In re Blixreth* – petitioning creditor's eligibility requires that its claim is entirely undisputed

Involuntary Bankruptcy Petition

- Meaning of Bona Fide Dispute – Courts Are Divided (cont'd)
  - Contrary holding: *In re General Aeronautics Corporation* – U.S. Bankruptcy Court, Utah – petitioning creditors' claims not subject to bona fide dispute where debtor disputed part of the claims as long as undisputed remainder of the claims meets statutory threshold

Involuntary Bankruptcy Petition

- Debtor Continues To Operate its Business and Use, Acquire and/or Dispose of Property Until Entry of an Order For Relief on the Involuntary Petition (Known as "Gap Period")
- Prior to Order For Relief, Petitioning Creditors, or Other Party in Interest, Can Seek Appointment of an Interim Trustee to Preserve Property of the Estate or Prevent Loss to Estate
  - Very hard to get this relief
- Court Could Require Petitioning Creditors to Post a Bond to Indemnify Debtor for Amounts Payable by Petitioning Creditors

Involuntary Bankruptcy Petition

- If Debtor Opposes Involuntary Petition, and Provided Petitioning Creditors' Debts Are Not Subject to *Bona Fide Dispute as to Liability or Amount*, Creditors Must Prove Debtor Generally Not Paying Debts as They Become Due
- Successful Petitioning Creditors Awarded Order For Relief and Can Seek Recovery of Fees (Subject to Court Approval)

Involuntary Petition Sanctions Upon Dismissal

- Unsuccessful Petitioning Creditors Could Be Directed to Pay Debtor's Costs and Attorneys' Fees in Defending Involuntary Petition
  - No bad faith prerequisite
- Petitioners' Bad Faith Filing Could Also Subject Them To:
  - Debtor's actual damages arising from involuntary bankruptcy filing
  - Punitive damages
  - Could be substantial dollars
- Discourages Creditors From Joining in an Involuntary Petition Without Doing Appropriate Diligence

Automatic Stay

- Does Not Apply to Actions Against Non-Debtors
  - Drawing on letter of credit
  - Claims vs. guarantors that are not debtors
    - Personal guarantors and non-debtor affiliate guarantors
    - Exception – Chapter 13 co-debtors with consumer debts
- **Consequences of Stay Violation**
  - Contempt of court
  - Sanctions
    - Including legal fees
  - Judgments obtained in violation of the stay are generally void *ab initio* (as if they didn't exist at all)

Automatic Stay Impact on Terms Switch

- Can goods suppliers switch from credit to COD/CIA terms?
  - Permitted under agreement(s) with Debtor?
  - According to Uniform Commercial Code
  - Response to threats of breach of contract/violation of automatic stay
  - Moving for relief in Bankruptcy Court

Bankruptcy Checklist – What Should Creditors Be Doing When They Hear Their Customer Filed Chapter 11

- File Preservation/Info Gathering
  - Preserve credit and other files – paper/electronic, including emails
  - Preserve telephone logs, recorded phone calls, if any, and cell phone texts
  - Information gathering regarding proof of claim
    - Invoices, bills of lading and delivery receipts, in particular re: goods received by Debtor within 20 days of bankruptcy filing in support of Section 503(b)(9) 20 day goods priority claim
    - Common carriers only keep records for a maximum period of nine (9) months so obtain these records immediately upon learning of a bankruptcy proceeding

Bankruptcy Checklist – What Should Creditors Be Doing When They Hear Their Customer Filed Chapter 11

- Information gathering re preference exposure and defenses
  - Payments received within 90 days of bankruptcy filing
  - Analysis of preference defenses
    - Invoices/proof of delivery or bills of lading for new value defense
      - Common carriers only keep records for a maximum period of nine (9) months so obtain these records immediately upon learning of a bankruptcy proceeding
    - Pay history for subjective ordinary course defense
      - At least two years of data should be maintained
    - Credit group data for objective ordinary course defense

Obtaining Bankruptcy Court Filings

- Download Documents Filed With the Bankruptcy Court From Court's Website Generally Via PACER Electronic Case Filing (ECF) Online Service
  - www.pacer.gov
  - Must sign up and pay (currently $.10 per page)
- If Claims Agent Has Been Appointed, Agent's Website Usually Contains Court Docket – Free Access to Court Filings and Claims Register
- In-House or Outside Counsel Can File Notice of Appearance With the Court and Request Receipt of Notices in the Case

Review First Day Pleadings In Chapter 11 Cases

- Affidavit or Declaration in Support of First Day Motions Provides Detailed Information Useful to Creditors
  - What caused the chapter 11 proceeding?
  - What the Debtor intends to do in the immediate future?
- Chapter 11 Financing/Use of Cash Collateral
- Payment of Pre-Petition Payroll and Employee Benefits
- Prohibiting Utilities From Altering, Refusing or Discontinuing Service
- Payment of Pre-Petition Shipping and Related Charges
- Critical Vendor
- Procedures for Treatment of 503(b)(9) claims

Importance of DIP Financing/Cash Collateral Order

- DIP (Chapter 11) Financing Order Approves New Financing by Either
  - New lender
  - Existing lender
- Cash Collateral Order Allows Debtor to Use Cash Proceeds of Lender's Collateral
  - Debtor's accounts and/or inventory

DIP Financing/Cash Collateral Order

- Usually Approved On an Interim Basis Shortly After Chapter 11 Filing and Then on a Final Basis
- Usually Includes a Budget of Approved Debtor Expenditures
  - Generic description of expenditures, e.g., vendor payments
- Cash Collateral Use Might Not be as Flexible as DIP Financing

DIP Financing/Cash Collateral Order

- Contain Lots of Onerous Lender-Friendly Provisions
  - Beware of "roll-up" – little or no new advances
  - Beware of provision that grants lien and extends superpriority claim status re: preference claims
  - Beware of prohibition of payment of section 503(b)(9) priority claims
  - Beware of provision wiping out or subordinating creditors' setoff rights
  - Beware of waiver of trustee's right to surcharge secured lender under section 506(c) and 552(b); exorbitant fees

Risks of Doing Business With a Chapter 11 Debtor: *Delco Oil* Decision

- **Do Not Do Any Business Until Court Has Approved Financing/Use of Cash Collateral!**
- Per Bankruptcy Code Sections 549(a) and 550(a), a Trustee Can Seek Recovery of Debtor's Unauthorized Post-Petition Payments
- U.S. 11th Circuit Court of Appeals, in *Delco Oil*, Held Debtor Was Not Authorized to Use its Lender's Cash Collateral, Violating § 363(c)(2) of the Bankruptcy Code
  - Court upheld trustee's recovery of Debtor's post-petition payments totaling approximately $2 million to a vendor for post-petition purchases
  - Didn't matter that vendor lacked knowledge of improper payments

Post *Delco Oil* Decisions

- Courts Have Distinguished the 11th Circuit's *Delco Oil* Decision
- *In re Wood Treaters LLC*, United States Bankruptcy Court, Middle District of Florida – 2012 and 2013 Decisions
- *In re Indian Capital Distributing Inc.*, United States Bankruptcy Court, District, New Mexico, 2011
- Both Courts Held the Trustee Must Prove Injury to Estate to Prevail in a Section 549 Avoidance Action
  - Purchase price not fair value
  - Goods resold at a loss

Claims Priority

Secured Claims
(minus professional fees and other carveouts and surcharge claims)

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Administrative Expense Claims
[Includes Section 503(b)(9) Priority "20 Day Goods" Claims in Favor of Goods Sellers]

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Lower Level Priority Claims

↓

General Unsecured Claims

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Equity

Claims Priority

- Secured Creditors – Highest Priority
  - DIP Lender – usually obtains a senior secured "priming" lien with priority over essentially all other creditors
  - Prepetition secured lenders
  - Federal and state tax liens
  - State law liens (e.g., mechanic's liens)/judgment liens
  - Superior status of Trust Fund (PACA, Packers & Stockyards, and Builders) Claimants

Claims Priority

- Next In Line: Administrative Claims
  - "Superpriority" Administrative Claims
    - Senior to all other administrative expenses
    - DIP lender (to the extent not secured)
    - Prepetition lender (adequate protection)
  - Actual and necessary costs and expenses of bankruptcy
  - Examples:
    - Post-petition trade credit, rent, wages
    - Post-petition professional fees
    - Section 503(b)(9) claims for "20 Day" Goods

Risk of Post-Petition Trade Credit: What If You Guess Wrong?

- Meltdown in Chapter 11: Administrative insolvency
  - Insufficient funds to pay all chapter 11 administrative priority claims in full
  - **hhgregg** – appliance/consumer electronics retailer
  - Toys "R" Us
  - Sears?

Claims Priority

- Next In Line: Lower Level Priority Claims
  - Wages/salaries/compensation earned within 180 days of the bankruptcy filing up to
    - Capped at $12,850 per employee for bankruptcy cases filed from 4/1/2016 through 3/31/2019, and
    - Capped at $13,650 per employee for bankruptcy cases filed on and after 4/1/2019
  - Employee benefit plan contribution claims arising from services rendered within 180 days of bankruptcy filing, subject to above employee caps
  - Certain taxes
  - Other special claims

Claims Priority

- Next In Line: Pre-Petition General Unsecured Claims
  - Pre-petition unsecured trade claims
  - All treated equally
  - Disposition at conclusion of case
    - Exception – critical vendor

Critical Vendor Orders

- *There is no Bankruptcy Code Provision that Expressly Authorizes Critical Vendor Status*
- It is Court-Created Based on Doctrine of Necessity
  - Limited by 7th Circuit Court of Appeals decision in *Kmart Corporation*, but doctrine still alive in most jurisdictions
- Critical Vendor Status Contingent on Court Approval Authorizing (Not Directing) Debtor's Payment of Claims of Creditors Deemed Critical or "Essential" to Debtor's Ongoing Business/Successful Reorganization
  - Exception to claims priority rules
  - Debtor designates critical vendors
  - Frequently focused on Section 503(b)(9) "20 day goods" priority claims

Critical Vendor Orders

- Standard for Debtor Determining Critical Vendors
  - Debtor has broad discretion
  - Courts have the final say
  - Courts have reached varying holdings on when a vendor is "critical"
    - Some courts prohibit preferred critical vendor status
    - Among those courts allowing critical vendor status, some are stricter than others
    - Vendor less likely to be deemed critical if it is obligated to continue selling to Debtor via pending supply contract

Critical Vendor Orders

- No Assurance of 100% Payment of Critical Vendor's Claim – Subject to Negotiation
- Quid Pro Quo: Generally, Creditors Receiving Such Payments Must Agree to Extend Post-Petition Credit (Entitled to Administrative Priority Status) and Other Terms
- Critical Vendor Agreement Should Be Reviewed by Counsel
  - Negotiate payment and other terms
  - Be careful of fine print that prevents any change in prices and other non-credit related terms
  - Risk of disgorgement of critical vendor payments if creditor stops extending credit
  - Negotiate default provision that gives critical vendor an out

Critical Vendor Orders

- Designation as a Critical Vendor Does Not Protect Against Preference Risk
  - Affirmed by bankruptcy court decision
    - *In re Personal Communications Devices, LLC*, U.S. Bankruptcy Court, Eastern District of New York
  - Release of preference claim vs. critical vendor – hard to get!
  - Impact of Debtor's post-petition payment of pre-petition "new value" invoices on new value defense to preference claim

Executory Contracts

- Non-Debtor Parties Must Perform Under Executory Contracts Until they are Assumed or Rejected
  - Goods seller or service provider, if bound by contract, is required to continue selling/providing services to debtor
  - Is non-debtor obligated to continue extending credit post-petition if required by contract?
    - Contract terms and/or UCC credit remedies (adequate assurance/stoppage of delivery) might permit switch to CIA
    - Be careful!
  - Creditor's Failure to Fulfill Terms of Any Executory Contract Risks Debtor's Assertion of Claims of Breach of Contract and Violation of Automatic Stay

Executory Contracts

- Assumption, Rejection and Assignment Require Court Approval, and Assignment Often Is Part of the Sale of the Debtor's Business and/or Assets
- Time Frame for Assumption/Rejection of Most Executory Contracts
  - Any time prior to or upon confirmation of plan
  - Non-debtor party can seek to shorten period by moving in bankruptcy court compelling debtor to assume/reject contract within specified time period, and/or seeking adequate protection (*e.g.*, deposit, letter of credit or cash in advance terms)
    - Very difficult to obtain early in case

Executory Contracts

- Profitable or Necessary Contracts Are Often Assumed/Assigned
  - Cure of all arrears and defaults
  - Adequate assurance of future performance by Debtor or Assignee
- Unprofitable/Burdensome Contracts are Rejected
  - Creditors are entitled to assert a contract rejection damages unsecured claim and stop performing
  - Creditors are entitled to assert an administrative priority claim for goods delivered or services rendered post-petition

Carefully Review Notices of Cure Amounts

- Creditors Should Carefully Review Proposed Cure Amounts Payable to Creditors on Assumed and/or Assigned Executory Contracts to Assure Consistency With the Amount of Creditors' Claims
  - Cure amounts generally listed in schedule attached to notice sent to all creditors that are parties to executory contracts in the context of sale of Debtor's assets/business
  - Be prepared to retain counsel to object to cure amount or lack of adequate assurance of future performance

Unenforceability of "Ipso Facto Clauses"

- Ipso Facto Clause Unenforceable in Bankruptcy
  - Modifies/terminates contract upon insolvency/poor financial condition, including customer's bankruptcy
  - "Safe Harbor" exception

Creditor Can Force Issue

- Motion to Compel Assumption or Rejection Via 11 U.S.C. §365(d)
  - Court may order the trustee/debtor to determine within specified period of time to assume or reject such contract
- Debtor's Quick Assumption of Contract (rare!)
- Debtor's Payment of Post-Petition Claims
- Debtor May Agree to Release Creditor From Contract
- Creditor May be Able to Negotiate More Favorable Terms or Risk Backstop, Such as Letter of Credit or Deposit
- Debtor May Agree to Deadline for Assumption/Rejection

Section 503(b)(9) "20 Day" Administrative Priority Claims

- Administrative Claim for the Value of Goods Debtor Received Within 20 Days of Bankruptcy Filing
- 20 Day Goods Must be Sold to the Debtor in the Ordinary Course of Debtor's Business
- Safety Net for Trade Creditors that Supply Goods Not Services!
  - Replaces reclamation as effective trade creditor remedy

Assertion of "20 Day" Goods Administrative Claims And Timing Of Payment

- General Rule – Section 503(b)(9) Request/Allowance Requires Notice and a Hearing
  - No automatic administrative claim without court approval
- No Federal Bankruptcy Rule Specifying Manner In Which To Assert Section 503(b)(9) Priority Claims
- *In re Richfield Equities*, Bankruptcy Court, Eastern District of Michigan Required Assertion of Section 503(b)(9) Priority Claim by Motion
  - Rejects assertion of Section 503(b)(9) claim via proof of claim
- Timing of Payment - Most Courts Have Rejected Immediate Payment Over Debtor's Objection
  - Instead Payment Upon Confirmation of Plan or Earlier if Motion to Pay Section 503(b)(9) Claim is Filed

Deadline to Assert "20 Day" Goods Administrative Claims

- No Deadline to Assert Section 503(b)(9) Claim in Statute
  - Local Bankruptcy Rules May Create Deadline
    - U.S. Bankruptcy Court, Eastern District, Michigan
      - Local Bankruptcy Rule 3003-1 – Deadline to file proof of claim, or § 503(b)(9) motion in chapter 11 case: 90 days after first date set for Section 341 meeting of creditors
    - U.S. Bankruptcy Court, District of Massachusetts
      - Local Bankruptcy Rule 3002-1 – Deadline to file request for allowance of § 503(b)(9) claim: 60 days from first scheduled 341 meeting date

Deadlines/Assertion Re "20 Day" Goods Administrative Claims

- Courts Are Also Setting Deadlines for Asserting Section 503(b)(9) Priority Claims
  - One deadline to file claims that includes Section 503(b)(9) priority claims and all other general unsecured claims
  - Alternate deadline: Separate deadline for asserting Section 503(b)(9) claims
- Courts Are Also Prescribing Manner of Asserting Section 503(b)(9) claims, either
  - On the same claim form as the creditor's general unsecured claim

    -or-
  - On a special proof of claim form solely related to Section 503(b)(9) claims

One Of Section 503(b)(9)'s Most Frequently Litigated Issues: Meaning Of Receipt Of Goods

- Section 503(b)(9) Does Not Define "Receipt"
- Actual Possession (UCC)?
  - UCC-2(103)(1)(c)
    - "Receipt of goods means taking physical possession of them"
- Constructive Possession?

Decision of U.S. Court of Appeals For Third Circuit in *In re World Imports, Ltd.*: Goods "Received" Upon Physical Possession

- "Received" in Section 503(b)(9) Means Debtor's or Its Agent's Actual Physical Possession of Goods
  - Reversed lower court rulings that a debtor "received goods" upon delivery to common carrier based on FOB (Free on Board) port of shipment (in China)
    - Rejected applicability of Convention of Contracts for the International Sale of Goods

Decision of U.S. Court of Appeals For Third Circuit in *In re World Imports, Ltd.*: Goods "Received" Upon Physical Possession

- Court Relied on Dictionary Definitions of "Receive", Uniform Commercial Code Definition of "Receipt" and Old Third Circuit Case Law Dealing With How Reclamation Rights Required Physical Possession
- Receipt Does Not Occur Until Termination of Seller's Ability to Stop Delivery of Goods
  - Upon debtor's/agent's actual physical possession of goods
    - Who qualifies as an agent? Common carrier?
- Third Circuit's Ruling is Beneficial to Trade Creditors (Goods Sellers)
  - Delayed occurrence of "receipt" of goods might increase the amount of goods received within Section 503(b)(9)'s 20 day window, particularly for goods being imported from outside U.S.

One Of Section 503(b)(9)'s Most Frequently Litigated Issues: Meaning Of Receipt Of Goods

- Drop Shipment?
  - Creditor ships goods to third party at Debtor's instruction
    - Debtor's agent
    - Debtor's customer
  - Debtor never had actual physical possession of goods

Receipt Of Goods: Drop Shipment

- *In re Momenta, Inc.* – U.S. District Court New Hampshire affirming U.S. Bankruptcy Court Decision—
  - Receipt includes buyer's physical or constructive possession of goods
  - Buyer does not obtain constructive possession of goods that are delivered to buyer's customer under drop shipment arrangement
  - Constructive possession narrowly interpreted to occur upon proof of receipt of goods by buyer's agent
  - Adopted Black's Law Dictionary definition of "drop shipment delivery" as a "manufacturer's shipment of goods directly to the consumer rather than initially to a wholesaler"
- Creditor's Section 503(b)(9) Priority Claim re Drop Shipped Goods Denied

Drop Shipment Decision in Delaware

- *SRC Liquidation LLC (f/k/a Standard Register)* – U.S. Bankruptcy Court, Delaware
- Court Denied Section 503(b)(9) Priority Status to Seller that Delivered Goods to a Common Carrier for Shipment to Debtor's Customer During the 20 Days Before the Debtor's Chapter 11 Filing
  - Court relied on Third Circuit's *World Imports* ruling
  - Neither debtor nor debtor's agent took physical possession of the goods
  - Common carrier was not debtor's agent

Receipt of Goods – Drop Shipment: A Contrary View

- None of the Drop Shipment Decisions Considered Official Comment 2 to Section 2-705 of the Uniform Commercial Code Which States:

  "[r]eceipt by the buyer includes receipt by the buyer's designated representative, the sub-purchaser, when shipment is made direct to him and the buyer himself never receives the goods."

- *In re ADI Liquidation Inc. (formerly known as Associated Wholesalers Inc./White Rose)* – U.S. Bankruptcy Court, Delaware Decision Rejected This Argument in Analogous Case Involving Seller, Debtor Coop, and Coop Members

Receipt Of Goods: Drop Shipment

- Can "Receipt" Be Defined in Parties' Agreement to Occur Upon Buyer's Customer's Receipt of the Goods?
- Suggested Language: "Receipt of any product by buyer shall immediately occur when buyer, buyer's bailee or other agent or designee receives either actual or constructive possession of such product. Constructive possession shall include, without limitation, receipt by an entity or individual (including, without limitation, buyer's customer) pursuant to a drop ship instruction or other delivery instructions from buyer. Constructive possession specifically does not require actual physical possession by the buyer."
- No Reported Court Decision that Allows "Contracting Around" Definition of "Receipt"

Debtor's Setoff Rights As A Defense To Section 503(b)(9) Priority Claims

- Chapter 11 Debtors Have Successfully Offset Pre-Petition Credits, Deductions, Chargebacks, Overpayments, Rebates, and Similar Claims Against a Creditor First In Reduction of the Amount Owing to a Creditor on their Section 503(b)(9) Priority Claims Instead of their Less Valuable General Unsecured Claims

Debtor's Setoff Rights As A Defense To Section 503(b)(9) Priority Claims

- *Circuit City Stores* (Bankruptcy Court, Eastern District of Virginia) *and In re ADI Liquidation, Inc.* (Bankruptcy Court, District of Delaware) Decisions
  - Debtor permitted to setoff pre-petition credit claims in reduction of Section 503(b)(9) priority claims
  - The courts invoked a little known Bankruptcy Code Section 558:
    - "The estate shall have the benefit of any defense available to the debtor…"
  - The Debtor could also offset pre-petition credits claims against creditors' unpaid post-petition administrative claims — VERY DANGEROUS!
    - Post-petition credit should be conditioned on Debtor's agreement not to deduct pre-petition credits and other related claims

Debtor's Setoff Rights As A Defense To Section 503(b)(9) Priority Claims

- Proposed Contractual Fixes
  - "Buyer waives right to assert pre-petition credits, deductions, chargebacks, overpayments, rebates and similar claims if buyer is "not in good standing" with Seller (i.e., Buyer is past due or otherwise in default; out of business)"
  - "Buyer waives the right to assert any right of setoff, recoupment or any other defense with respect to any credits, deductions, chargebacks, overpayments, rebates and similar claims that Seller owes Buyer to reduce Buyer's indebtedness to Seller"

Debtor's Setoff Rights As A Defense To Section 503(b)(9) Priority Claims

- Proposed Contractual Fixes (continued)
  - "Seller shall be permitted to apply all credits, deductions, chargebacks, overpayments, rebates and similar claims owed to the Buyer in reduction of indebtedness owing by the Buyer to Seller as determined by Seller at its sole discretion." (*e.g.*, apply credits against oldest invoices first)
  - Enforceability of proposed provisions on screens 52 and 53 in bankruptcy? No reported decision addresses this
    - Note following caveat in AWI opinion:

      "…I conclude that there is a presumption that the claimants' prior course of dealing, industry standards and *contract* do not operate as a waiver of the Debtors' equitable remedies. However, if a claimant believes that its course of dealing or contractual language provide a good faith basis for arguing that the Debtors have waived their equitable remedies, then the claimant shall have the right to a hearing on the merits of their claim to rebut the presumption."

Preference Claim As Grounds For Disallowance Of Section 503(b)(9) Administrative Priority Claim (Section 502(d) of the Bankruptcy Code)

- The Courts Are Divided Over Whether a Preference Claim Can be Invoked to Disallow a Section 503(b)(9) Priority Claim
- One View: Preference Claim Not Grounds for Disallowance of Section 503(b)(9) Priority Claim
  - *In re Energy Conversion Devices, Inc. and Plastech Engineered Products, Inc.* – U.S. Bankruptcy Court, Eastern District of Michigan decisions
  - *In re TI Acquisition LLC* – U.S. Bankruptcy Court, Northern District of Georgia
  - *In re Momenta, Inc.* – U.S. Bankruptcy Court, New Hampshire
- Contrary View: Debtor could assert preference claim as basis for temporarily disallowing Section 503(b)(9) priority claim
  - *In re Circuit City* – U.S. Bankruptcy Court, Eastern District, Virginia

Bankruptcy Reclamation

- Avoidance Powers of Trustee Subject to Rights of Seller of Goods That has Sold Goods to Debtor in Ordinary Course of Seller's Business to Reclaim Such Goods if Debtor has Received Such Goods While Insolvent, Within 45 Days Before Commencement of Bankruptcy Case

Bankruptcy Reclamation

- Written Reclamation Demand Required
- Demand must be received by Debtor no later than 20 days after Bankruptcy Filing
- Debtor's Insolvency – balance sheet
- Reclamation rights limited to goods in Debtor's possession
  - Only remedy – return of goods; no other statutory remedies
  - No provision for alternative remedy of administrative claim if reclamation is denied

Bankruptcy Reclamation

- **WARNING !!! A SELLER'S RECLAMATION RIGHTS ARE STILL SUBJECT TO THE PRIOR RIGHTS OF A CREDITOR WITH A SECURITY INTEREST IN SUCH GOODS**
- Are Reclamation Claims Rendered Valueless by Debtor's Pre-Petition Secured Inventory Lender?
  - Courts divided: *Dairy Mart* vs. *Phar Mor*

Reclamation Catch 22

- Circuit City Stores (U.S. District Court, Eastern District of Virginia)
  - Creditor forfeited reclamation rights by just sending written reclamation demand and then failing to seek recovery of goods
- Catch 22: Creditor That Pursues Reclamation Rights Would Still Not Be Entitled to Relief Because Pre-Petition Lenders' Blanket Floating Lien on Inventory Renders Reclamation Claim Valueless
- Useless Remedy?
- Election of remedies?

Bankruptcy Reclamation Under BAPCPA – A Hollow Remedy?

- Sounds Great on Paper
- Recovery prospects uncertain, but possible!
- Send reclamation demand and don't ignore this remedy!

Preference: Elements Of Claim

- Any Transfer of an Interest of the Debtor in Property;
- To or for the Benefit of a Creditor;
- On Account of an Antecedent Debt Owed by Debtor Before Transfer:
  - CIA payment not a preference
- Made While the Debtor was Insolvent;
  - On or within 90 days before bankruptcy filing; or
  - Between 90 days and one year before bankruptcy filing for transfers to insider creditors; and
- That Enables Such Creditor to Receive More Than Such Creditor Would Receive if:
  - The case were a Chapter 7 case;
  - The transfer had not been made; and
  - Such creditor received payment to the extent provided by other provisions of Title 11.
  - The greater than liquidation recovery requirement

Preference Defenses: Contemporaneous Exchange For New Value (COD)

- Transfer was *Intended* by Debtor and Creditor to be Contemporaneous Exchange for New Value; and
- Transfer was Substantially Contemporaneous Exchange
- Examples:
  - COD transaction: payment tendered for delivery of goods
    - Risk of bounced COD check/ACH payment; replacement payment not subject to this defense

Preference Defenses: New Value

- Creditor Extending Credit to Debtor After Payment, that was Not Secured and Not Paid by Otherwise Unavoidable Transfer
- Goods Shipped/Services Provided on Credit Terms Following Payment Reduce Preference Exposure
- New Value Cannot Be Applied to Subsequent Payments

Preference Defenses: Paid For New Value

- Paid for New Value May Count to Reduce Preference Exposure
- U.S. Circuit Courts of Appeal are Divided on Whether Paid New Value Counts, though Trend is Toward Allowing Paid New Value:
  - 4th, 5th, 8th, 9th, and most recently 11th say Yes!
  - 7th says No!
  - 3rd Circuit's prior "No" is now in question – Likely open
  - Other Circuits open

Critical Vendor Preference Risk

- Does Critical Vendor's Receipt of Post-Petition Payment of *Pre-Petition* Claim Result in Loss of Section 547(c)(4) New Value Defense to Preference Claim?
  - U.S. Court of Appeals 3rd Circuit Decision – *In re Friedman's* counts new value paid post-petition pursuant to court order because new value is determined as of bankruptcy filing date – A snap shot as of the petition date.
  - Other U.S. Circuit Courts of Appeal have not ruled on this issue
  - Other lower courts have disqualified new value paid post-petition
  - Suggestion: Critical vendor order should either release preference claims against vendor or preserve new value defense
    - Might be hard to obtain, unless creditor has great leverage

Is Paid Section 503(b)(9) Claim Eligible As New Value?

- YES: *In re Commissary Operations, Inc.* U.S. Bankruptcy Court, Middle District of Tennessee
  - New value window closes on bankruptcy filing date (same ground cited by 3rd Circuit court in *In re Friedman's*)
  - New value defense not impacted by post-petition payments of new value
  - Section 503(b)(9) claims impaired if excluded from new value defense

Paid Section 503(b)(9) Claim Is Not Eligible As New Value

- NO: *In re Circuit City Stores* (U.S. Bankruptcy Court, Eastern District of Virginia) and *In re TI Acquisition LLC* (U.S. Bankruptcy Court, Northern District of Georgia)
- Paid Section 503(b)(9) Priority Claim Does Not Satisfy Section 547(c)(4)'s Requirement That "The Debtor Did Not Make An Otherwise Unavoidable Transfer To or For the Benefit of Such Creditor"
- Creditor Gets a Double Dip If It Can Use Fully Paid/Funded Section 503(b)(9) Claim As Part Of Its New Value Defense

Ordinary Course Of Business Preference Defense

- Transfer Was in Payment of a Debt Incurred by the Debtor in the Ordinary Course of Business or Financial Affairs of the Debtor and the Creditor; and
- Subjective Test – Made in the Ordinary Course of Business or Financial Affairs of the Debtor and the Creditor; OR
- Objective Test – Made According to Ordinary Business Terms
- Creditor Can Choose Most Beneficial (Subjective or Objective) Prong of Ordinary Course of Business Defense

Subjective Component of Ordinary Course of Business Defense

- Courts Have Been Inconsistent and Unpredictable in Applying Subjective Component of Ordinary Course of Business Defense
- Each Side Can Pick a Methodology to Support its Position
- Encourages Expensive Litigation

Ordinary Course of Business: Subjective – Litigated Issues

- Range of Views
  - How long of a payment history?
    - 1 Year?
    - 2 Years? Bankruptcy Court, Southern District, New York decision: *Quebecor World*
    - Longer?

Ordinary Course of Business: Subjective – Baseline for Comparing Preference vs. Prior Payment

- Range of Payments
  - All payments?
  - Modified range?
  - Payments <u>only</u> when Debtor is healthy? (*Circuit City* Bankruptcy Court decision in Eastern District, Virginia)
- *Sparrer Sausage Co.* – 7th Circuit U.S. Court of Appeals Decision
  - 7th Circuit rejected Bankruptcy Court's use of historical (pre-preference period) baseline of only 64% of invoices paid
  - Court accepted historical baseline of 88% of invoices paid (more generous to creditor)
  - Like *Circuit City*, did not overturn Bankruptcy Court's refusal to consider payments within 7 months of start of preference period when the Debtor was not "financially healthy"

Ordinary Course of Business: Subjective – Baseline for Comparing Preference vs. Prior Payments

- Comparison of Average Days to Pay/Days Late Prior to and During Preference Period
- *Archway Cookies* Bankruptcy and District Court decisions in Delaware –
  - Payments subject to subjective ordinary course defense, notwithstanding approximately 5 day difference in average days to payment during historical period (42.3 days) compared to preference period (47.2 days)
- Bucket Analysis – Examining Payments by Grouping – Accepted – *Quebecor World*, Bankruptcy Court, Southern District of New York
  - Risk of skewed analysis

Sierra Concrete Design Inc.; United States Bankruptcy Court, Delaware: Comparing Preference vs. Prior Payments

- *Quebecor World*, Bankruptcy Court, Southern District of New York – Subjective Ordinary Course of Business Defense Inapplicable
  - 30 days off average [27.56 average days outstanding prior to preference period vs. 57.16 average days outstanding during preference period] too much
    - Court relied on weighted average – not disputed
- *Sierra Concrete Design*, Bankruptcy Court, Delaware - Defendant Proved Subjective Ordinary Course of Business Defense After Trial
  - Did not matter that debtor paid invoices 27.9 days faster during preference period
    - Average days-to-pay prior to preference period was 55.22 days
    - Average days-to-pay during preference period was 27.3 days

First Time Transactions May Fall Within Subjective Ordinary Course of Business Defense

- Decision of U.S. Court of Appeals for 10th Circuit – *In re C.W. Mining Co.*
  - Payment on account of first time transaction between debtor and creditor might satisfy the subjective part of ordinary course of business defense
    - Payment made 2 days before due date (within terms)
    - No evidence of creditor collection activity
- 6th, 7th and 9th Circuits Agree

Subjective Ordinary Course of Business Preference Defense – Facts That Defeat Subjective Ordinary Course of Business On the Numbers

- Consistency In Timing of Payments Prior to and During Preference Period Alone Might Not Be Sufficient to Prove Subjective Component of Ordinary Course of Business Defense
- Threats to Subjective Component
  - Change in the form of payment during preference period (regular check to wire, ACH, etc.)
  - Change in method of invoicing (electronic to paper)
  - Change in credit terms
  - Imposition of credit limit/enforcement of existing credit limit
  - Threats to stop shipment; imposition of credit holds
  - Change in mode of delivery (regular mail to Federal Express or hand delivery)

Ordinary Course Of Business Preference Defense – Ordinary Business Terms Alternative: Objective Component

- Proof Requirement Is Currently Evolving
- General Standard? Transfer Was Not So Unusual or Idiosyncratic As To Render It An Aberration In The Relevant Industry
- Which Industry to Consider?
  - Creditor's industry?
  - Debtor's industry?
  - Industry based on companies similar to creditor selling to companies similar to Debtor?
  - General business standards/sound business practice?

Ordinary Course Of Business Preference Defense – Ordinary Business Terms Alternative: Objective Component

- Includes Range of Industry Terms
  - No need to prove single set of business terms within an industry
  - Ordinary Business Terms may vary widely across industries
- Creditor's Changing of Business Terms Does Not Necessarily Result in Loss of Objective Ordinary Course of Business Defense
  - Are new terms frequently used in industry?

Ordinary Course Of Business: Objective (Ordinary Business Terms)

- Proper Methodology For Determining A Payment's Consistency with Industry Practices is Evolving
- Example: *In re Waterford Wedgewood, Inc.* (Bankruptcy Court, Southern District of New York)
  - Proper method for determining whether a payment is made in accordance with ordinary business terms: whether payment occurred within one standard deviation of the industry average
- Contrast with *Hayes Lemmerz International Inc.* (Bankruptcy Court, Delaware)
  - Court rejected expert testimony proffered by Trustee limiting industry practice to median range of payments for middle 50% of surveyed companies

Ordinary Business Terms Information Sources

- Credit Research Foundation – National Summary of Domestic Trade Receivables
- Risk Management Association
- S&P Capital IQ
- D&B Industry Reports
- CreditRiskMonitor (www.crmz.com)
- Trade Associations / Trade Credit Groups
- NACM Expert Witnesses
- American Society of Association Executives (www.asaenet.org)
- Thomson Reuters Expert Witness Services
- Outside expert witness services
- Lay witness with either:
  - Specific knowledge of industry practices, or
  - Objective information gained outside subjective experiences as employee of creditor/defendant.

Small Preference Defense

- Section 547(c)(9) – Trustee May Not Avoid a Transfer Involving Aggregate Value of Property That is Less Than
  - $6,425 for bankruptcy cases filed from 4/1/2016 through 3/31/2019
  - $6,825 for bankruptcy cases filed on and after 4/1/2019

Recent Bankruptcy Code Amendment Changes To Preference Law

- Effective February 19, 2020
- Section 547(b) Amended to Add Following Due Diligence Requirement For Filing Preference Litigation
  - "(b) Except as provided in subsections (c) and (i) of this section, the trustee may, based on reasonable due diligence in the circumstances of the case take into account a party's known or reasonably knowable affirmative defenses under subsection (c), avoid any transfer of an interest of the debtor in property…."
  - Preference defendants still retain burden of proving preference defenses

Increased Venue Limits On Small Claims

- The Venue Provision That Forces a Trustee or Debtor-in-Possession to Commence Litigation on Smaller Claims in the District Court Where the Defendant Resides Has Been Increased From $13,650 to $25,000
  - Trustees/debtors-in-possession less likely to commence suit on preference and other claims seeking recovery of less than $25,000
- Problem: Legislation Does Not Address Division of Courts Over Applicability of Venue Limit to Preference and Other Avoidance Actions

Another Preference Defense

- Delaware Bankruptcy Court Decision: *Quantum* Foods
  - Court approved, apparently for first time, a creditor's setoff of its unpaid allowed Chapter 11 administrative expense claim for goods sold and delivered post petition to reduce creditor's preference liability on a dollar for dollar basis
  - Both creditor's administrative claim and preference claim against the creditor arose post-petition satisfying mutuality requirement for setoff
- Conflicting Holding Rejecting Setoff Preference Defense – *1984 Georgia Steel Holding* – Bankruptcy Court, Middle District of Georgia

Prepare To Defend Against The Preference Attack

- At the time of the Bankruptcy Filing – Gather and Preserve all data
  - Download and save all electronic files of payment history up to two to three years before the commencement of the 90 day preference period
  - Save invoice copies, both paid and unpaid and all Statements of Account
  - Obtain and save all delivery receipts and/or bills of lading
    - Get delivery receipts from common carrier at inception of case
  - Save entire credit file, including credit application, contracts, if any, and all financial information available.
    - Preserve all notes in file, correspondence and emails
  - Begin the review of potential defenses

React and Respond To Initial Preference Demand Letter

- DO NOT IGNORE DEMAND
- Request a list of all checks that make up payment claim and copies of cancelled checks or proof of wire transfers with remittance instructions
- Confirm all payments were received
  - Check for NSF, return to maker, etc. checks
  - If payments not actually received, tell the trustee immediately and preference demand may disappear
- Confirm the date when each payment cleared the debtor's bank
  - If more than 90 days, there is no preference
- Statute of Limitations: has it expired or is it about to expire
- Can the Trustee actually sue you
  - No preference actions can be commenced on claims totaling less than $6,825 in the aggregate in cases filed on or after April 1, 2019, and on claims totaling less than $6,425 in the aggregate in cases filed prior to April 1, 2019
    - Trustees most likely to send demand letter anyway

Pre-suit Preference Checklist

- Review defense strategy with management
- Develop a Preference Analysis including New Value and Ordinary Course of Business Defenses
- Develop a game plan and negotiation thresholds
- Consult with your bankruptcy attorney
- Communicate defenses to trustee
- NOTE: Pre lawsuit discussions might not happen if close to expiration of statute of limitations as trustee may not have time to negotiate if deadline is near
- Was the Debtor Insolvent at the time of the bankruptcy filing?
  - Check the bankruptcy schedules
  - Check any financial statements you may have received from debtor

Preparing Your Preference Defense Analysis

- Unique Aspects of New Value Analysis
- New Value must follow received payment
- When was the payment delivered/when did you actually receive the payment?
  - Wire
  - Check
- When did you actually release new goods?
  - Must be after receipt of payment
  - Same day?

Preference Checklist Once Lawsuit Commenced

- Check all dates
  - Was the lawsuit commenced before the Statute of Limitations expired
  - Determine your answer deadline (often 30 days)
    - DO NOT ALLOW A DEFAULT TO BE TAKEN
- Try to obtain an extension of time to answer the complaint to provide an opportunity for you to demonstrate defenses and resolve lawsuit
- Timely contact your bankruptcy attorney if an extension is not granted to timely answer the complaint and not allow a default to be taken

QUESTIONS?

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WANDA BORGES, ESQ. is the principal member of Borges & Associates, LLC, a law firm based in Syosset, New York. For more than thirty-five years, Ms. Borges has concentrated her practice on commercial litigation and creditors rights in bankruptcy matters, representing corporate clients and creditors' committees throughout the United States in Chapter 11 proceedings, out of court settlements, commercial transactions and preference litigation. She is a member and Past President of the Commercial Law League of America and has been an Attorney Member of its National Board of Governors, a Past Chair and current member of the Bankruptcy Section, a past member of the executive council of its Eastern Region and is currently the Immediate Past Chair of its Creditors' Rights Section. She is a member of several bar associations, including the American Bar Association and the American Bankruptcy Institute. Ms. Borges serves on its Board of Directors of the International Association of Commercial Collectors, of which her firm is an associate member. She is an internationally recognized lecturer and author on various legal topics including Bankruptcy Issues such as 503(b)(9) claims and preferences, the Uniform Commercial Code, ECOA, FCRA, antitrust law, and current legal issues such as Credit Card Surcharge issues and current proposed legislation that may impact trade credit grantors. Ms. Borges has authored, edited and continues to contribute to numerous publications including Thomson West's Enforcing Judgments and Collecting Debts in New York, NAB's book Out of the Red and into the Black, the BCCA's Credit & Collection Handbook, The Financial Manager, the CLLA's Commercial Law World Magazine. She has authored the treatise "Hidden Liens, Who is Entitled to What?" and NACM's Antitrust, Restraint of Trade and Unfair Competition: Myth Versus Reality. She is a contributing author to NACM's Manual of Credit and Collection Laws and Principles of Business Credit. She has co-authored The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 – An Overhaul of U.S. Bankruptcy Law, also published by the NACM and her article has "Uniform Voidable Transactions Act (US) has been published by the British Law Journal Insolvency Intelligence. In November, 2010, Ms. Borges received the "Robert E. Caine Award for Leadership" from the Commercial Law League of America. In April 2015, Ms. Borges received a "Woman of Distinction" award from St. Catharine Academy, her high school alma mater. Ms. Borges has been included in the New York Super Lawyers – Metro Edition list (Bankruptcy & Creditor/Debtor Rights) each year since 2009.

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Among his various legal recognitions, Bruce received the Top Hat Award in 2011, a prestigious annual award honoring extraordinary executives and professionals in the credit industry. He was co-chair of the Avoiding Powers Committee that worked with the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 and also participated in ABI's Great Debates at their 2010 Annual Spring Meeting, arguing against repeal of the special BAPCPA protections for goods providers and commercial lessors, and was a panelist for a session sponsored by the American Bankruptcy Institute. He is a frequent presenter at industry conferences throughout the country, as well as a prolific author regarding bankruptcy and creditors' rights topics in various legal and trade publications.

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