TEN THINGS ENERGY CREDIT AND LEGAL PROFESSIONALS SHOULD KNOW ABOUT BANKRUPTCY

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I. INTRODUCTION—THE "BIG PICTURE"

Does bankruptcy seem like a legal morass, shrouded in mystery? How do you reconcile all of the details and nuances of bankruptcy with the rest of the legal system? Is there any hope of collecting money justly owed in spite of A bankruptcy? How do you make sense of it all?

After nearly thirty years working with credit and legal professionals in the energy industry grappling with these questions, I have distilled certain bankruptcy fundamentals which are essential for those non-bankruptcy specialists involved in energy credit and collections. Don't try to memorize the Bankruptcy Code! Instead, develop a solid foundation by understanding these fundamentals that credit and legal professionals truly need to know (including attention to new rules of law created by the 2005 bankruptcy reforms).

The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act made substantial changes to a comprehensive array of bankruptcy concepts, most of which changes went into effect on October 17, 2005. The business credit community is affected not only by the so-called "business" bankruptcy revisions, but also by the "personal" or "consumer" bankruptcy amendments which will govern liquidation or reorganization of proprietorships and individual partners in a partnership, or personal guarantors of corporate obligations.

II. THE TEN THINGS YOU SHOULD KNOW:

1. Stay informed (utilizing resources such as Creditors' meetings, debtor examinations, Notices of Appearance, and Pacer), and never rely on your intuitions.

Although the intuitive notions of substantial justice, which drive American commerce, center upon the virtues of contract, the enforcement of debts, and the unassailable finality of the "closed deal"

(particularly when it is in writing and signed), bankruptcy swims upstream against all of these fundamental concepts.

Our state laws, which are generally predicated upon a common law legacy, afford a full spectrum of remedies for enforcement of debts justly owed. Bankruptcy excuses a debtor from paying just debts. This is what discharge, "fresh start," and the automatic stay are all about.

State law enforces private contracts between a debtor and creditor, requiring performance when it is due. Bankruptcy, on the other hand, allows a debtor to choose whether it will perform future obligations or not, regardless of the preferences of the creditor. A bankrupt may either assume or reject executory contracts, depending solely upon the criterion of whether future adherence to such contracts will be advantageous to him.

State law enforces legitimate transfers and assignments of interest between a debtor and creditor. Bankruptcy, however, permits the debtor to take back transfers of money or property under certain circumstances. The "strong arm" powers set forth in the Bankruptcy Code can be relentless in the havoc they can wreak on the business of the transferee who has relied upon the supposed efficacy of the transfer.

State law puts a premium on prompt action by creditors. Bankruptcy, though, takes many of the rewards out of promptness and diligence. A creditor who diligently garnishes the debtor's bank account to collect a just debt on the eve of bankruptcy, will typically have to give back the garnished funds as a "preference" under the Bankruptcy Code.

Many of your intuitions about what is "right" or what is "legal" will have to be set aside as we explore the procedures and policies of bankruptcy. The 2005 reform amendments, which have created many exceptions to long-standing bankruptcy principles (as well as exceptions to those exceptions!), make it even less likely that you can "guess" or intuit your way to a correct analysis of bankruptcy's impact on a commercial receivable claim or contract.

As a simple illustration, consider the standard bankruptcy default clause frequently encountered in commercial credit transactions. One very significant feature of Section 365 of the Bankruptcy

Code is that it invalidates and renders ineffectual provisions in an ongoing contractual relationship that define bankruptcy itself as an event of default, purporting to trigger rights in the non-bankrupt party. Commercial creditors may have a hard time believing that these types of bankruptcy-default clauses, which seem so intuitively "right," do not legally mean what they say (at least at the Bankruptcy Courthouse).

Besides having a clear understanding of bankruptcy principles, and how they often conflict with your intuitions, you must know what is going on with your debtor and its bankruptcy case. There are a number of vehicles serving this purpose. The Bankruptcy Code provides for a meeting of creditors which is essentially an opportunity for the debtor to be examined under oath about his financial condition, reasons for bankruptcy, books and records, schedules and financial statements, as well as the validity and extent of claims and liens.

> **§ 341. Meetings of creditors and equity security holders.**
>
> **(a) Within a reasonable time after the order for relief in a case under this title, the United States trustee shall convene and preside at a meeting of creditors.**
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> **(b) The United States trustee may convene a meeting of any equity security holders.**
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> **(c) The court may not preside at, and may not attend, any meeting under this section including any final *meeting of creditors. Nothwithstanding any local court rule, provision of a State constitution, any otherwise applicable nonbankruptcy law, or any other requirement that representation at the meeting of creditors under subsection (a) be by an attorney, a creditor holding a consumer debt or any representative of the creditor (which may include an entity or an employee of an entity and may be a representative for more than 1 creditor) shall be permitted to appear at and participate in the meeting of creditors in a case under chapter 7 or 13, either alone or in conjunction with an attorney for the creditor. Nothing in this subsection shall be construed to require any creditor to be represented by an attorney at any* meeting of creditors.**
>
> **§ 343. Examination of the debtor.**
>
> **The debtor shall appear and submit to examination under oath at the meeting of creditors under section 341(a) of this title. Creditors, any indenture trustee, any trustee or examiner in the case, or the United States trustee may examine the debtor. The United States trustee may administer the oath required under this section.**

A debtor's attendance at the creditors' meeting is crucial to allow creditors and the Trustee the ability to gather information; however, the Court may waive a debtor's attendance when the debtor is too ill, is incarcerated, or has other reasons beyond his control. In such instances, the Court may permit creditors and the Trustee to question the debtor by telephone or interrogatories, or to examine a spouse or co-debtor.

Bankruptcy Amendments effective October 17, 2005. Non-attorneys may represent creditors at Creditors' Meetings in consumer cases under Chapters 7 and 13.

Creditors' meetings may present only a very cursory opportunity for an individual creditor to investigate at length the circumstances concerning the debtor's financial affairs which may be of interest in connection with such creditor's particular claim or rights in the bankruptcy. Fortunately, the Bankruptcy Rules provide a mechanism for a deposition procedure which the creditor, or any party-in-interest, can invoke for a more detailed and extensive examination.

Rule 2004. Examination.

(a) ***Examination on Motion.*** **On motion of any party in interest, the court may order the examination of any entity.**

(b) ***Scope of Examination.*** **The examination of an entity under this rule or of the debtor under § 343 of the Code may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge. In a family farmer's debt adjustment case under chapter 12, an individual's debt adjustment case under chapter 13, or a reorganization case under chapter 11 of the Code, other than for the reorganization of a railroad, the examination may also relate to the operation of any business and the desirability of its continuance, the source of any money or property acquired or to be acquired by the debtor for purposes of consummating a plan and the consideration given or offered therefor, and any other matter relevant to the case or to the formulation of a plan.**

(c) ***Compelling Attendance and Production of Documents.*** **The attendance of an entity for examination and for the production of documents, whether the examination is to be conducted within or without the district in which the case is pending, may be compelled as provided in Rule 9016 for the attendance of a witness at a hearing or trial. As an officer of the court, an attorney may issue and sign a subpoena on behalf of the court for the district in which the examination is to be held if the attorney is admitted to practice in that court or in the court in which the case is pending.**

(d) ***Time and Place of Examination of Debtor.*** **The court may for cause shown and on terms as it may impose order the debtor to be examined under this rule at any time or place it designates, whether within or without the district wherein the case is pending.**

(e) ***Mileage.*** **An entity other than a debtor shall not be required to attend as a witness unless lawful mileage and witness fee for one day's attendance shall be first tendered. If the debtor resides more than 100 miles from the place of examination when required to appear for an examination under this rule, the mileage allowed by law to a witness shall be tendered for any distance more than 100 miles from the debtor's residence at the date of the filing of the first petition commencing a case under the Code or the residence at the time the debtor is required to appear for the examination, whichever is the lesser.**

A Rule 2004 examination permits a broad range of inquiry into all matters relevant to the debtor's financial affairs, which includes an inquiry into the validity of a creditor's disputed claim;

accordingly, that creditor himself may be deposed to determine the facts and circumstances surrounding his claim.

To insure that you are on the "mailing list" for a particular bankruptcy case, in line to receive copies of all filed pleadings, notices, and orders, it is your option to file a Notice of Appearance and request for service of notices. However, in this age of Internet access on every desktop, the handiest way to stay informed about a case to the degree of your personal preference, is through the federal court public case information access system, Pacer (Public Access to Court Electronic Records): http://pacer.uspci.uscourts.gov/. This subscription system will inexpensively provide docket sheets, claims registers, and critical deadlines for virtually every bankruptcy case, and includes downloading of scanned images of pertinent documents for almost all federal districts and bankruptcy cases.

2. The risks of involuntary cases often overwhelm the rewards.

A. Voluntary

A bankruptcy petition may be filed by any entity that may be a debtor under the various chapters of the Code. Insolvency is not a condition to any form of voluntary bankruptcy action. No adjudication is necessary to "legitimate" the bankrupt status of the debtor. The filing of the petition itself operates as an order for relief.

Bankruptcy Amendments effective October 17, 2005. Chapter 7 (liquidation) of the Bankruptcy Code has been amended to state that a case may be dismissed for abuse, including the prospect of bad faith or abuse shown by the totality of the circumstances. For the first time in U.S. bankruptcy history, creditors and bankruptcy Trustees have the right to bring abuse motions against debtors whose incomes exceed a state median income standard. Individual debtors above the state median income standard are scrutinized under the "means test" to determine if they are presumed to be guilty of abuse in filing under Chapter 7. Current monthly income is reduced by expenses allowed under the IRS expense standards and other particular deductions, including the payments due on secured and priority debts over a period of sixty months following the filing of the bankruptcy petition. A presumption of Chapter 7 filing abuse applies if

the net income over sixty months is at least the lesser of $10,000.00 or 25% of the general unsecured claims, but not less than $6,000.00.

B. Involuntary

A bankruptcy may be forced, against the wishes of the debtor, by the requisite number of creditors. Generally, three creditors with unsecured claims totaling at least $13,475.00 must join in the involuntary petition. If, however, the debtor has less than 12 unsecured creditors, a single creditor with an unsecured claim of at least $13,475.00 is good enough. The involuntary petition may be contested by the debtor, in which case it is incumbent upon the petitioning creditors to prove either that (1) the debtor is not paying debts as they come due, or (2) within 120 days before the petition was filed, a receiver took possession of substantially all of the debtor's property.

If an involuntary proceeding fails and is dismissed, the petitioning creditors may be liable for actual and punitive damages, attorneys' fees, and costs. A solicitation to join in an involuntary petition should always be handled with kid gloves (and the advice of an attorney) because the decision to participate carries with it a risk of failure and exposure. See *e.g.*, *Basin Electric Power Coop. v. Midwest Processing Co.*, 769 F.2d 483, 13 C.B.C.2d 500 (8th Cir.), cert. denied, 474 U.S. 1083 (1985).

> **§ 303. Involuntary cases.**
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> **(b) An involuntary case against a person is commenced by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title—**
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> **(1) by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute, *as to liability or amount,* or an indenture trustee representing such a holder, if such *noncontingent, undisputed* claims aggregate at least $13,475 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims;**
>
> **(2) if there are fewer than 12 such holders, excluding any employee or insider of such person and any transferee of a transfer that is voidable under section 544, 545, 547, 548, 549, or 724(a) of this title, by one or more of such holders that hold in the aggregate at least $13,475 of such claims.**

3. Always file a timely and accurate Proof of Claim.

When a debtor files a voluntary bankruptcy petition, it is supposed to include a schedule that sets forth the names and addresses of the debtor's secured and unsecured creditors. The list of creditors the

debtor files with the petition frequently will include the amount of debt admittedly owed to each of the listed creditors. This is the first available filed public document that a creditor can consult to verify whether its claim is recognized.

Bankruptcy Amendments effective October 17, 2005. If a creditor, within 90 days before a voluntary bankruptcy, provides the debtor with an account number and a specified address, then any bankruptcy notice to be sent by the debtor to the creditor must be sent to that address and include the account number.

§ 342. Notice

(c)*(2)(A)* ***If, within the 90 days before the commencement of a voluntary case, a creditor supplies the debtor in at least 2 communications sent to the debtor with the current account number of the debtor and the address at which such creditor requests to receive correspondence, then any notice required by this title to be sent by the debtor to such creditor shall be sent to such address and shall include such account number.***

Whether or not a Chapter 7 or 13 creditor is listed or identified in the schedules or statement of financial affairs, they must file a Proof of Claim to preserve their claim and any right to ultimate distribution. In Chapter 11 cases, by contrast, filing of a Proof of Claim is (theoretically) discretionary, allowing the creditor to "rely on the scheduling" of his claim by the debtor, unless (1) a claimant has actual notice of the Chapter 11 case and is not scheduled, or (2) the creditor's claim is scheduled as disputed, contingent, or unliquidated. The best practice on behalf of a creditor is to always file a Proof of Claim, whether or not the claim is secured, unsecured, or claims a priority, and regardless of whether or not it is a 7, 11, or 13 case.

The timing of the Proof of Claim is critical. The "bar date" for Chapter 7 and Chapter 13 cases is 90 days from the date set for the § 341 meeting of creditors. In Chapter 11 cases, the Court will set the "bar date" by order. Never miss the bar date, in any case, as it is a rigid statute of limitations with very few exceptions.

Rule 3001. Proof of Claim.

(a) ***Form and Content.*** **A proof of claim is a written statement setting forth a creditor's claim. A proof of claim shall conform substantially to the appropriate Official Form.**

(b) *Who May Execute.* **A proof of claim shall be executed by the creditor or the creditor's authorized agent except as provided in Rules 3004 and 3005.**

(c) *Claim Based on a Writing.* **When a claim, or an interest in property of the debtor securing the claim, is based on a writing, the original or a duplicate shall be filed with the proof of claim. If the writing has been lost or destroyed, a statement of the circumstances of the loss or destruction shall be filed with the claim.**

(d) *Evidence of Perfection of Security Interest.* **If a security interest in property of the debtor is claimed, the proof of claim shall be accompanied by evidence that the security interest has been perfected.**

The importance of correctly filling out the Proof of Claim in all of its essential ingredients cannot be overstated. Failure to properly complete the Proof of Claim form or to carefully draft a Proof of Claim pursuant to the Bankruptcy Rules can result in the debtor or Trustee successfully objecting to the claim's substantive or procedural validity. Caution should be used in insuring that the Proof of Claim has attached the appropriate exhibits to document the claim. Since criminal penalties apply to filing a false claim, accuracy is essential and any doubts as to the efficacy of the claim should be disclosed.

Once a Proof of Claim is filed, it is presumptively valid and deemed allowed under Section 502(a) of the Bankruptcy Code. It is incumbent upon the debtor, the Trustee, or other party-in-interest, to object to a creditor's claim, at which point issue is joined and, although the objector has the burden of going forward with evidence, the claimant has the burden of persuasion in proving the claim, just as in any non-bankruptcy litigation over its validity, extent, and nature.

Rule 3001. Proof of Claim.

(f) *Evidentiary Effect.* **A proof of claim executed and filed in accordance with these rules shall constitute prima facie evidence of the validity and amount of the claim.**

Rule 3007. Objections to Claims.

An objection to the allowance of a claim shall be in writing and filed. A copy of the objection with notice of the hearing thereon shall be mailed or otherwise delivered to the claimant, the debtor or debtor in possession and the trustee at least 30 days prior to the hearing. If an objection to a claim is joined with a demand for relief of the kind specified in Rule 7001, it becomes an adversary proceeding.

Objections can either be procedural (raising issues such as filing after the bar date or deficient documentation) or substantive (challenging the underlying merits of the claim). Certain forms of relief, such as subordination or lien avoidance, require that an Adversary Proceeding, or lawsuit, be filed

under Bankruptcy Rules 7001, et seq. The full array of discovery and pre-trial motions and procedures is available in these types of contested proceedings. The end result of such litigation is a determination by the Court of allowance or disallowance of the claim, coupled with an adjudication of the extent and nature thereof.

As might be expected, the debtor or the Trustee will do its utmost to reduce the number of claims against the bankruptcy estate. Given that little is usually available for distribution to unsecured creditors, objecting to deficient claims is an inexpensive, efficient, and relatively prompt way to eliminate unsecured claims and increase the overall return for selected creditors.

Proper characterization of a claim as either secured or unsecured is critical because a mischaracterization can result in a loss of advantage and options for the creditor. Calling a claim secured when in fact it is undersecured may leave the creditor with recourse to his collateral only, and no right to participate as an unsecured creditor for the deficiency portion. On the other hand, calling a claim unsecured when in fact it is secured to some degree can result in a waiver or abandonment of the collateral. Secured creditors should ideally prepare their Proof of Claim to accurately reflect not only their secured status, but also to preserve any rights to the extent that they are unsecured. A right of setoff, entitling the creditor to reduce a receivable amount by a payable due from its counterparty, is "security" for purposes of a Proof of Claim, and can be waived by characterizing the claim as unsecured.

The Proof of Claim filed by the fully secured creditor should include the security agreement and any of its exhibits. Not only is this mandated by the official form, but inclusion of documentation that evidences the perfection of the lien can help forestall disputes with the debtor, Trustee, or unsecured creditors over rights to the collateral. Attach evidence of a judgment if you have one. Attach evidence of filing if you recorded anywhere. The attachment of such documents is especially important in the case of secured creditors whose lien arises outside of Article 9 of the Uniform Commercial Code. For instance, appropriate lien affidavits and invoices should accompany mechanic's and materialmen's lien claims.

4. Never violate the automatic stay.

An immediate benefit to the debtor in filing a bankruptcy petition is an automatic injunction, applicable to every pre-bankruptcy creditor, precluding any effort to enforce or collect upon a pre-bankruptcy right or claim. This is part of the overall philosophy of "fresh start" and "breathing room" which underlies the current bankruptcy law. No matter how far along a creditor may be in enforcing his pre-bankruptcy rights against the debtor under State law, he must "cease and desist." The automatic stay is triggered by the filing of a bankruptcy petition. It is immaterial whether the creditor knows about it or not. The automatic stay continues until the bankruptcy case is closed or dismissed, or the debtor receives a discharge.

Virtually all creditor collection activity is enjoined--just as if the Bankruptcy Judge had ordered the creditor not to bother the debtor.

§ 362. Automatic stay.

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities, of--

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) **the commencement or continuation of a proceeding before the United States Tax Court concerning ~~the debtor~~ *a corporate debtor's tax liability for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the date of the order for relief under this title.***

Some creditors have a cavalier attitude about the stay, or think that the debtor has some obligation to prove his entitlement to the protection of the stay. Such creditors proceed at their peril because willful violation of the automatic stay can result in liability for actual and punitive damages, attorneys' fees, and costs.

§ 362. Automatic stay.

(k) *(1)* **~~An~~ *Except as provided in paragraph (2), an* individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.**

(2) ***If such violation is based on an action taken by an entity in the good faith belief that subsection (h) applies to the debtor, the recovery under paragraph (1) of this subsection against such entity shall be limited to actual damages.***

The automatic stay is not, however, a completely impenetrable obstacle. A party-in-interest (usually a secured creditor hoping to repossess collateral) may approach the Bankruptcy Court for relief from the automatic stay on the following grounds: (1) due to "cause," which includes a lack of "adequate protection" of the movant's interest in property, or (2) due to the debtor having no equity in the encumbered property, as well as such property not being necessary to reorganization.

§ 362. Automatic stay.

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest;

(2) with respect to a stay of an act against property under subsection (a) of this section, if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization; ~~or~~

Sometimes the moving creditor may have other reasons for lifting the stay which may fall under the umbrella of "cause." For example, the filing of a bankruptcy petition automatically stays a State

Court appeal. However, the Bankruptcy Judge may, on the ground of "cause," allow the stay to be lifted to permit the appeal to go forward for purposes of determining the rights or responsibilities of the debtor.

Bankruptcy Amendments effective October 17, 2005. If a new bankruptcy is filed within one year after an earlier dismissed bankruptcy was pending, the automatic stay terminates 30 days after the new case is filed, unless the Court decides on motion to extend the stay on a finding that the new bankruptcy is filed in good faith. If a bankruptcy is filed after two or more dismissed bankruptcies were pending in the previous year, no automatic stay goes into effect at all. On motion the Court may order that the stay take effect on a finding that the latest bankruptcy is filed in good faith.

5. Collect in spite of the bankruptcy, when you can, using tools such as reclamation, reaffirmation, and assumption.

Where a seller of goods discovers a buyer to be insolvent he may *refuse* delivery except for cash and may *stop* delivery under Uniform Commercial Code ("UCC") § 2.705 relating to stoppage in transit. A person is insolvent who either has ceased to pay his debts in the ordinary course of business, or cannot pay his debts as they become due, or is insolvent within the meaning of the federal bankruptcy law, that is, the balance sheet test. Policy: It is unfair to require the seller to deliver on credit to an insolvent buyer only to get a small percentage on the dollar pursuant to the buyer's insolvency proceedings, *e.g.*, an assignment for benefit of creditors under state law or straight liquidation bankruptcy under federal law.

But where does the seller stand when he *delivered* goods to the buyer on credit without taking or retaining some sort of security interest in the sold goods per UCC Article 9 Secured Transactions? Here the seller is an unsecured creditor with no interest in the sold goods and with the result that upon liquidation of the buyer's estate per insolvency proceedings, the seller would receive only a small percentage of his claim. However, suppose the seller discovers the buyer has received goods on credit while insolvent. This amounts to a tacit business misrepresentation of solvency by the buyer and therefore is "fraudulent" against the particular seller. Likewise if the buyer furnishes the seller with a false financial statement

indicating solvency (when the buyer was insolvent), this would probably be an explicit business misrepresentation of solvency. Should not this "defrauded seller" be in a somewhat more favorable position?

The UCC provides that where the seller discovers that the buyer has received goods on credit while insolvent, the seller may *reclaim* the goods upon demand made within ten days after the receipt of the goods. An exception to this ten day limitation is made when a written misrepresentation of solvency has been made to the particular seller within three months prior to the delivery.

The intervention of bankruptcy during the ten day period extends the reclamation deadline.

UCC § 2.702 Seller's Remedies on Discovery of Buyer's Insolvency

(a) Where the seller discovers the buyer to be insolvent he may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery under this chapter (Section 2.705).

(b) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

Bankruptcy Amendments effective October 17, 2005. The Code has been amended to finally clarify that a seller's right of reclamation of goods delivered on the brink of bankruptcy is subject to the prior perfected rights of a lienholder with a security interest in such goods (previously, the caselaw was mixed). The timeframes for reclamation have also been relaxed. Reclamation will now be available as to goods received by the debtor within 45 days before bankruptcy. The seller will have until 45 days after receipt of the goods to demand reclamation, or within 20 days after commencement of bankruptcy if the 45 day period expires after bankruptcy. The Bankruptcy Court will no longer have the discretion to deny reclamation by granting an administrative priority to the seller, but even sellers who do not make a timely reclamation demand may have an administrative claim nonetheless as regards goods delivered within 20 days before bankruptcy, sold to the debtor in the ordinary course of business.

When a business files bankruptcy (whether for liquidation or reorganization), the debtor will likely be a party to a number of contracts which are somewhere in mid-term. While the Bankruptcy Code

does not define the phrase "**executory contract**," it is most often interpreted to mean **one which requires some *significant future performance* from *both* parties**. Obviously, a contract would not be executory if the only performance yet required is payment from the debtor. Section 365(a) of the United States Bankruptcy Code provides that the bankruptcy Trustee (the debtor-in-possession in a Chapter 11 case) may: (1) reject an executory contract that is considered to be burdensome to the estate; (2) assume and retain an executory contract that is considered to be beneficial to the estate; or (3) assume and assign an executory contract that would be valuable to a third-party, and therefore, contribute value to the estate.

> **§365. Executory contracts and unexpired leases.**
>
> **(a) Except as provided in . . . subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.**

Bankruptcy Code §365 states:

> **§365. Executory contracts and unexpired leases.**
>
> **(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee--**
>
> **(A) cures, or provides adequate assurance that the trustee will promptly cure, such default *other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph*;**
>
> **(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and**
>
> **(C) provides adequate assurance of future performance under such contract or lease.**

The trustee's rejection of an executory contract is a Bankruptcy Code-sanctioned breach and termination of the contract, retroactive to the date of the bankruptcy filing. Upon rejection, the debtor has no further liability to perform the contract in the future. Any past performance due from the debtor is

allowed as a claim against the bankruptcy estate for which the creditor would hope to receive some payment along with other creditors *i.e.*, a Proof of Claim. If security interests in collateral have been created, the resulting claim may be deemed secured; but otherwise, the claim arising from rejection is like any other unsecured claim.

Assumption of an executory contract involves the Trustee's promise to cure any default in past performance and to accept the benefits and the burdens of the contract for the future. If the debtor assumes the contract, the creditor has greater assurance that the debts, past and present, will be paid.

The Bankruptcy Court must approve the Trustee's decision (with an opportunity for objection by other parties in interest), but the courts generally allow the Trustee to freely exercise business judgment as to how the interests of the estate are best served in deciding which contracts to assume and which to reject. The timing of assumption or rejection is a function of whether the case is a "straight bankruptcy" or a rehabilitative proceeding.

The Bankruptcy Code was designed to facilitate the discharge of the debtor's pre-petition obligations, *i.e.*, "fresh start." Pursuant to §524 of the Bankruptcy Code, all discharged debts are rendered totally uncollectible, unless the debtor chooses to repay them voluntarily. Obviously, it is in the creditor's best interest to avoid the discharge of that creditor's claim, if any such avoidance of discharge is feasible under the facts and circumstances of a given bankruptcy case.

Only individuals (not corporations) can earn a discharge under Chapter 7 of the Code. Discharge in Chapter 7 cases is governed by Section 727 of the Code.

Discharge is earned in Chapter 11 cases in connection with confirmation of a plan of reorganization under Section 1141(d)(1)(A) of the Code. A corporation is eligible for discharge under Chapter 11, but only if the plan does not contemplate liquidation and termination of business. Discharge is earned in Chapter 13 cases upon the debtor's completion of all payments called for under his plan, under Section 1328(a) of the Code. Corporations cannot be Chapter 13 debtors.

Bankruptcy Amendments effective October 17, 2005. The previous *six year* period is increased to subject a Chapter 7 debtor to denial of discharge if he received a Chapter 7 or 11 discharge in a case filed within *eight years* of the filing of the pending case.

In general, the Bankruptcy Code tends to favor the discharge of pre-petition debt. Reaffirmation agreements contractually carve such debts out of the general discharge. Because reaffirmation agreements are closely scrutinized by Bankruptcy Courts, it is extremely important that any such agreement be carefully negotiated and precisely worded, with due regard for the exact facts and circumstances of the individual case.

Subsections (c) and (d) of §524 of the Bankruptcy Code provide for the possibility of a valid and enforceable agreement which may be made between the debtor and the holder of a claim, which may effectively waive the discharge of that particular claim, and may reaffirm the pre-petition debt, while providing for continuation of the pre-petition relationship between the parties. If the leverage is there to negotiate such an agreement, in the face of the Bankruptcy Code's technical requirements, the net result of this procedure is much akin to the position the creditor has when executory agreements are assumed: pre-bankruptcy debt is recovered and the supply relationship continues post-bankruptcy. Creditors having only an open account with a bankrupt debtor should typically discuss with their counsel the possibility of negotiating a §524 reaffirmation of that contract.

Recognizing that a private creditor has no obligation to do business with anyone (subject to any applicable regulatory limitations), the principal consideration for such reaffirmations can often be structured in terms of moving the creditor's discretion to do business *at all*. For example, in one case the Third Circuit Court of Appeals determined that:

> "[The creditor] did not violate §362 or §524 of the Bankruptcy Code merely by informing [the debtor] of its policy. Nothing in the Bankruptcy Code requires this creditor to do business with this debtor . . . . We therefore reject the proposition that a creditor violates section 362(a)(6) or 524(a)(2) of the Bankruptcy Code as a matter of law, merely by informing a bankruptcy petitioner that it will refuse to deal with her unless she reaffirms her debt."

Brown v. Pennsylvania State Employees Credit Union, 851 F.2d 81 (3rd Cir. 1988).

Bankruptcy Amendments effective October 17, 2005. Lengthy disclosures are now required by Bankruptcy Code Section 524 to be given to any debtor who reaffirms a debt (*i.e.* contractually agrees to except the debt from bankruptcy discharge). Among such disclosures, the following are illustrative:

> ***"Reaffirming a debt is a serious financial decision. The law requires you to take certain steps to make sure the decision is in your best interest. If these steps are not completed, the reaffirmation agreement is not effective, even though you have signed it."***
>
> ***"Your right to rescind (cancel) your reaffirmation agreement. You may rescind (cancel) your reaffirmation agreement at any time before the bankruptcy court enters a discharge order, or before the expiration of the 60-day period that begins on the date your reaffirmation agreement is filed with the court, whichever occurs later. To rescind (cancel) your reaffirmation agreement, you must notify the creditor that your reaffirmation agreement is rescinded (or canceled)."***
>
> ***"What are your obligations if you reaffirm the debt? A reaffirmed debt remains your personal legal obligation. It is not discharged in your bankruptcy case. That means that if you default on your reaffirmed debt after your bankruptcy case is over, your creditor may be able to take your property or your wages. Otherwise, your obligations will be determined by the reaffirmation agreement which may have changed the terms of the original agreement. For example, if you are reaffirming an open end credit agreement, the creditor may be permitted by that agreement or applicable law to change the terms of that agreement in the future under certain conditions."***

6. Don't miss opportunities to gain an advantage, such as objecting to exemptions, non-dischargeability, and plan objections.

Since the point in history when bankruptcy law lost its primarily punitive, penal character, statutory exemptions have allowed property to be reserved to the debtor in spite of the extent of the claims of his creditors.

Section 522 of the Code provides for an election by the debtor between non-bankruptcy state law exemptions, and a series of federal exemptions prescribed by the Code. Corporate debtors do not qualify for any exemptions.

Some states, like Texas, have liberal exemption laws. For example, Section 41.001 of the Texas Property Code exempts homestead property regardless of its value (if it amounts to less than ten acres), and Section 42.001 of the Texas Property Code carves out $30,000.00 worth of personal property for an individual or $60,000.00 worth for a family. Other states are much less liberal. In Illinois, for example, the homestead exemption is $7,500.00 worth of property!

Bankruptcy Amendments effective October 17, 2005. The debtor's exemptions, such as homestead, may now only be based on the law of the state where the debtor has lived for the 730 days before

the bankruptcy. If the debtor has not been in the same state for that period, then exemptions are based on the state where the debtor lived for the 180 days before that period (or the longest portion of the 180 days).

§ 522. Exemptions

(b)*(3) Property listed in this paragraph is—*

(A) subject to subsections (o) and (p) any property **that is exempt under Federal law, other than subsection (d) of this section, or State or local law that is applicable on the date of the filing of the petition at the place in which the debtor's domicile has been located for the ~~180 days~~ *730 days* immediately preceding the date of the filing of the petition~~, or for a longer portion of such 180 day period than in any other place~~** *or if the debtor's domicile has not been located at a single State for such 730-day period, the place in which the debtor's domicile was located for 180 days immediately preceding the 730-day period or for a longer portion of such 180-day period than in any other place*;

Following the 2005 reforms, the homestead does not include non-exempt property that the debtor disposed of within 10 years before bankruptcy with the intent to hinder, delay or defraud creditors.

§ 522. Exemptions

(o) For purposes of subsection (b)(3)(A), and notwithstanding subsection (a), the value of an interest in—

(4) real or personal property that the debtor or a dependent of the debtor claims as a homestead, shall be reduced to the extent that such value is attributable to any portion of any property that the debtor disposed of in the 10-year period ending on the date of the filing of the petition with the intent to hinder, delay, or defraud a creditor and that the debtor could not exempt, or that portion that the debtor could not exempt, under subsection (b), if on such date the debtor had held the property so disposed of.

A further 2005 embellishment is that a debtor may not exempt any part of his homestead exceeding $125,000.00 that he acquires in the 1215 days before the bankruptcy, unless such debtor acquired such interest by transfer from a previous homestead in the same state. A debtor who has been convicted of a felony that demonstrates the bankruptcy filing to be an abuse may not exempt a homestead interest exceeding $125,000.00.

§ 522. Exemptions

(p)(1) Except as provided in paragraph (2) of this subsection and sections 544 and 548, as a result of electing under subsection (b)(3)(A) to exempt property under State or local law, a debtor may not exempt any amount of interest that was acquired by the debtor during the 1215-day period preceding the date of the filing of the petition that exceeds in the aggregate $125,000 in value in—

(A) real or personal property that the debtor or a dependent of the debtor uses as a residence;

(B) a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence;

(C) a burial plot for the debtor or a dependent of the debtor; or

(D) real or personal property that the debtor or dependent of the debtor claims as a homestead.

(2) (A) The limitation under paragraph (1) shall not apply to an exemption claimed under subsection (b)(3)(A) by a family farmer for the principal residence of such farmer.

(B) For purposes of paragraph (1), any amount of such interest does not include any interest transferred from a debtor's previous principal residence (which was acquired prior to the beginning of such 1215-day period) into the debtor's current principal residence, if the debtor's previous and current residences are located in the same State.

§ 522. Exemptions

(q)(1) As a result of electing under subsection (b)(3)(A) to exempt property under State or local law, a debtor may not exempt any amount of an interest in property described in subparagraphs (A), (B), (C), and (D) of subsection (p)(1) which exceeds in the aggregate $125,000 if—

(A) the court determines, after notice and a hearing, that the debtor has been convicted of a felony (as defined in section 3156 of title 18), which under the circumstances, demonstrates that the filing of the case was an abuse of the provisions of this title[.]

If the debtor gets carried away claiming exemptions, a diligent creditor can create leverage for itself in the bankruptcy by objecting to claimed exemptions under Bankruptcy Rule 4003:

Rule 4003. Exemptions.

(a) *Claim of Exemptions.* **A debtor shall list the property claimed as exempt under § 522 of the Code on the schedule of assets required to be filed by Rule 1007. If the debtor fails to claim exemptions or file the schedule within the time specified in Rule 1007, a dependent of the debtor may file the list within 30 days thereafter.**

(b) *Objecting to a Claim of Exemptions.* **A party in interest may file an objection to the list of property claimed as exempt only within 30 days after the meeting of creditors held under § 341(a) is concluded or within 30 days after any amendment to the list or supplemental schedules is filed, whichever is later. The court may, for cause, extend the time for filing objections if, before the time to object expires, a party in interest files a request for an extension. Copies of the objections shall be delivered or mailed to the trustee, the person filing the list, and the attorney for that person.**

(c) *Burden of Proof.* **In any hearing under this rule, the objecting party has the burden of proving that the exemptions are not properly claimed. After hearing on notice, the court shall determine the issues presented by the objections.**

(d) ***Avoidance by Debtor of Transfers of Exempt Property.*** **A proceeding by the debtor to avoid a lien or other transfer of property exempt under § 522(f) of the Code shall be by motion in accordance with Rule 9014.**

The debtor can lose the important right of discharge in its entirety (rendering the bankruptcy filing a useless effort) by certain acts that frustrate the fundamental purposes of the Bankruptcy Code or are grossly inequitable to creditors. Such acts include fraudulent conveyances; unjustified failure to keep or preserve financial records; making a false oath; presenting a false claim; bribery; withholding books and records from the Trustee; or failure to satisfactorily explain loss or deficiency of assets. An objection to discharge in its entirety is raised by a creditor or other party-in-interest by a timely filing with the Bankruptcy Court.

Exceptions from discharge present grounds for carving a particular debt or class of debts out of the coverage of the discharge. The debtor is granted a discharge, but the particular debt in question is excepted and the creditor is free to pursue non-bankruptcy remedies even after the discharge order is issued. Creditors must file a timely request for determination of the dischargeability of their claim, and litigate with the debtor as necessary for adjudication of the ramifications of disputed facts.

Examples of obligations that are excepted from discharge include taxes; money, property, or services obtained through fraud; submission of false financial data relied on by a creditor; unscheduled debts; fraud by a fiduciary; child support and alimony; and willful and malicious tort liability.

Bankruptcy Amendments effective October 17, 2005. The Chapter 13 discharge is revised to now make fraud non-dischargeable. Section 523(a)(2) will (finally!) apply in Chapter 13 as well as in Chapter 7.

§ 523. Exceptions to discharge

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained, by—

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(B) use of a statement in writing—

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive[.]

§ 523. Exceptions to discharge

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny[.]

Under both Chapters 11 and 13 of the Bankruptcy Code, the debtor is expected to obtain approval ("confirmation") from the Court of a plan for repayment of some of the pre-bankruptcy debt. How much debt must be repaid is a function of some very complex provisions of the Bankruptcy Code. The Chapter 11 plan must meet the requirements of Section 1129 of the Code, including: classification of claims, limitations on impairment of claims, reservation to secured creditors of the indubitable equivalent of their liens, no unfair discrimination as to impaired classes of claims, *etc.* The Chapter 13 plan must meet the requirements of Section 1322 of the Code, including: submission of future earnings of the debtor to the Trustee for a plan period of five years, providing for full payment of priority claims, no unfair discrimination as to impaired classes of unsecured claims, *etc.*

Creditors seeking to gain leverage which may translate into benefits under the plan, or an advantage in related contested proceedings, will closely scrutinize the proposed plans under the Bankruptcy Code's requirements and pose timely objections which the debtor will see as an obstacle to the debtor's strategy for confirmation. It is important for the creditor to realize that the confirmed plan replaces all prior agreements to the extent of any inconsistency with such agreements.

7. Never trust the Trustee.

In every Chapter 7 case, every Chapter 13, and some Chapter 11 cases, there will be not only a Bankruptcy Judge, but also a Bankruptcy Trustee. Chapter 11 cases always commence with the debtor acting as its own Trustee (or "Debtor-In-Possession"); however, on motion of a party-in-interest who can prove that the Chapter 11 debtor is not measuring up as a Debtor-In-Possession, an independent Trustee can be appointed by the Court.

§ 323. Role and capacity of trustee.

(a) The trustee in a case under this title is the representative of the estate.

(b) The trustee in a case under this title has capacity to sue and be sued.

The Trustee can either be your friend or your enemy, depending on the issue. The Trustee can object to creditors' claims and try to un-do pre-bankruptcy transfers. But it is also the Trustee who amasses and safeguards the property of the estate, and can seek dismissal of the bankruptcy or object to the debtor's discharge.

§ 704. Duties of trustee.

(a) **The trustee shall--**

(1) collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest;

(2) be accountable for all property received;

(3) ensure that the debtor shall perform his intention as specified in section 521(2)(B) of this title;

(4) investigate the financial affairs of the debtor;

(5) if a purpose would be served, examine proofs of claims and object to the allowance of any claim that is improper;

(6) if advisable, oppose the discharge of the debtor;

(7) unless the court orders otherwise, furnish such information concerning the estate and the estate's administration as is requested by a party in interest;

(8) **if the business of the debtor is authorized to be operated, file with the court, with the United States trustee, and with any governmental unit charged with responsibility for collection or determination of any tax arising out of such operation, periodic reports and summaries of the operation of such business, including a statement of receipts and disbursements, and such other information as the United States trustee or the court requires; ~~and~~**

(9) **make a final report and file a final account of the administration of the estate with the court and with the Unites States trustee.**

8. Avoid being "strong-armed" by recording all transfers promptly and diligently.

A Bankruptcy Trustee may avoid certain pre-bankruptcy transfers made by the debtor of real or personal property that are not timely recorded or perfected. In other words, well-documented transfers or conveyances may simply be ignored in bankruptcy. The Trustee is given certain "hypothetical" powers, including the powers of a judgment-creditor and a bona fide purchaser for value without notice ("BFP"), that enable him to defeat the usual expectations of a transferee.

§ 544. Trustee as lien creditor and as successor to certain creditors and purchasers.

(a) **The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by--**

(1) **a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;**

(2) **a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or**

(3) **a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.**

A Debtor-In-Possession's knowledge of an improperly recorded mortgage does not prevent it from asserting the "strong-arm" clause of Section 544(a)(3) because Congress intended that actual knowledge of the debtor be irrelevant under that section. The Trustee, in exercising "strong-arm" powers,

such as hypothetical "BFP" status, is not bound by facts which are not evident of record. *Huber v. Danning*, 147 Bankr. 526 (9th Cir. 1992).

9. <u>Be prepared to defend preferences.</u>

Bankruptcy Code Section 547(b) sets out the elements of a voidable preference. The bankruptcy trustee may void any transfer of *property of the debtor* if he can establish:

(1) the transfer was "to or for the benefit of a creditor"; and

(2) the transfer was made for or on account of an "antecedent debt," *i.e.*, a debt owed prior to the time of the transfer; and

(3) the debtor was insolvent at the time of the transfer; and

(4) the transfer was made within 90 days before the date of the filing of the bankruptcy petition, *or*, was made between 90 days and 1 year before the date of the filing of the petition to an "insider"; and

(5) the transfer has the effect of increasing the amount that the transferee would receive in a Chapter 7 liquidation case.

§ 547 Preferences

(f) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

While the bankruptcy trustee has the benefit of this presumption of insolvency, it is a presumption which may be overcome with sufficient evidence in particular cases.

The hypothetical liquidation element, which essentially tests whether the transfer improved the creditor's position, will be satisfied unless the creditor was fully secured before the transfer or the property of the estate is sufficiently large to permit 100% payment to all unsecured claims.

Section 547(c)(1) of the Bankruptcy Code precludes the avoidance of a transfer to the extent that such transfer was:

a. intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

b. in fact a substantially contemporaneous exchange.

The so-called "contemporaneous exchange" defense was first delineated in *Dean v. Davis*, 242 U.S. 438 (1917), and later codified in Section 547(c)(1) of the Bankruptcy Code. "The justification for this exception is that transferring [property] in exchange for an infusion of [new property] does not harm existing creditors because it does not diminish the debtor's net assets." *Pine Top Insurance Co. v. Bank of America*, 969 F.2d 321, 324 (7th Cir. 1992). Also, Section 547(c)(1) strives to encourage transactions with beleaguered debtors by excluding from avoidance certain types of cash transactions. Stated differently, the contemporaneous exchange defense generally is not applicable to credit transactions.

There is an "ordinary course of business" defense to a preference in Section 547(c)(2) of the Bankruptcy Code, and determining what constitutes an "ordinary" transaction, the Bankruptcy Court may analyze factors such as timing, amount and manner of payment, and circumstances of transfer. Even if a debtor's business transactions are irregular, they may be considered "ordinary" if such transactions are consistent with the course of dealing between the particular parties and, under certain circumstances, courts may examine industry practices in addition to the parties' prior dealings.

Bankruptcy Amendments effective October 17, 2005. The ordinary course defense was amended to require proof of only two elements: (1) the debt was incurred in the ordinary course, and (2) either (a) the payment was made in the ordinary course between the debtor and creditor, or (b) the payment was made according to ordinary business terms. If the bankrupt is not a consumer, a preference is not recoverable for less than $5,475.00. The Deprizio Rule has been fully abolished: Non-insiders will not be subjected to a one-year preference look-back period merely because the transfer in question benefits an insider. The only proper venue for Trustee litigation to recover money is the District where the Defendant resides, if the case is against a non-insider based on a business debt of less than $10,950.00.

Section 547(c)(4) of the Bankruptcy Code precludes the avoidance of a transfer to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor–

a. not secured by an otherwise unavoidable security interest; and
b. on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

The Section 547(c)(4) defense "most obviously applies to revolving credit arrangements." "Protecting the creditor who extends 'revolving credit' to the debtor is not unfair to the other creditors of the bankruptcy debtor because the preferential payments are replenished by the preferred creditor's extensions of new value to the debtor." *Laker v. Vallette*, 14 F.3rd 1088, 1091 (5th Cir. 1994).

§ 546(a) Limitations on avoiding powers.

(a) An action or proceeding under section 544, 545, 547, 548, or 553 of this title may not be commenced after the earlier of--

(1) the later of--

(A) 2 years after the entry of the order for relief; or

(B) 1 year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or

(2) the time the case is closed or dismissed.

10. Understand the "safe harbor" for forward contracts, swap agreements, *etc.*

In much the same way that secured creditors are a "favorite" of bankruptcy law, physical delivery forward contracts and forward contract merchants (as well as various derivative financial transactions and their participants) also receive "favored" treatment under the Bankruptcy Code. This is because a legislative policy decision was made to protect the financial stability of contract counterparties who participate in the complex web of interrelationships that make up the forward contract trade (or derivative transactions) in particular industries, such as energy. Various black-letter rules of bankruptcy which present serious obstacles to the typical commercial creditor are inapplicable in the context of forward contract (or derivative) transactions.

As discussed above, the filing of a bankruptcy petition under any of the bankruptcy Chapters 7, 11, or 13 automatically gives rise to an injunction that precludes most creditor collection activity that would have been perfectly lawful before bankruptcy. Likewise, contract provisions that trigger a default upon the filing of bankruptcy are generally not enforceable because the Code seeks to reserve to the Trustee the decision of whether to assume or reject contracts that are in midstream on the bankruptcy filing date.

However, under a forward contract (or a swap agreement) which calls for the potential liquidation of obligations upon the filing of a bankruptcy petition, it is "business as usual" without regard to the automatic stay or the prohibition against bankruptcy defaults.

> **§ 556. Contractual right to liquidate, *terminate, or accelerate* a commodities contract or forward contract.**
>
> **The contractual right of a commodity broker, *financial participant,* or forward contract merchant to cause the liquidation, *termination, or acceleration* of a commodity contract, as defined in section 761 of this title, or forward contract because of a condition of the kind specified in section 365(e)(1) of this title, and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts, shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title. As used in this section, the term "contractual right" includes a right set forth in a rule or bylaw of a ~~clearing organization or contract market~~ *derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act)* or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.**

Similarly, post-bankruptcy setoffs (*i.e.* netouts) are forbidden under most commercial contracts unless a motion is made to the Bankruptcy Court and approval is given. Indeed, pre-bankruptcy setoffs during the last ninety days before bankruptcy are usually subject to the creditor's being required to disgorge any resulting improvement in position under §553 of the Bankruptcy Code.

However, setoffs under a forward contract are perfectly fine, without Bankruptcy Court involvement and without any prospect of disgorgement of eve-of-bankruptcy improvements in position.

> **§ 362. Automatic stay.**
>
> **(b) The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay—**
>
> > **(6) under subsection (a) of this section, of the setoff by a commodity broker, forward contract merchant, stockbroker, financial institutions, *financial participant,* or securities clearing agency of any mutual debt and claim under or in connection with commodity contracts, as defined in section 761 of this title, forward contracts, or securities contracts, as defined in section 741 of this title, that constitutes the setoff of a claim against the debtor for a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, arising out of commodity contracts, forward contracts, or securities contracts against cash, securities,**

or other property held by, *pledged to, under the control of,* or due from such commodity broker, forward contract merchant, stockbroker, financial institutions, *financial participant,* or securities clearing agency to margin, guarantee, ~~or~~ secure, or settle commodity contracts, forward contracts, or securities contracts.

As discussed above, the debtor's payments to creditors in the last ninety days before bankruptcy are generally subject to being set aside and recovered from the affected creditors, in spite of the legitimacy of the pre-existing obligations being paid.

However, payments by or to a forward contract merchant under a forward contract are immune from preference recovery, even if they would otherwise meet the test for a preference.

§ 546. Limitations on avoiding powers.

(e) Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, *financial participant,* or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

Since forward contracts are "golden," and seem to be exempt from so many of the usual strictures of bankruptcy, what is a "forward contract" and what is a "forward contract merchant?"

Bankruptcy Amendments effective October 17, 2005. The "safe harbor" protection for forward contracts, as well as various financial derivative contracts such as swap agreements, has been expanded. The usual black-letter bankruptcy rules concerning the effect of the automatic stay, preferences, pre- and post-bankruptcy setoffs, and unenforceability of bankruptcy default clauses are all abrogated in the case of forward contracts and financial derivatives.

§ 101. Definitions

(25) *The term* "forward contract" ~~means a contract~~ means—

***(A)* *a contract* (other than a commodity contract) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase transaction, reverse**

repurchase transaction, consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction~~, or any combined thereof or option thereon~~; ***or any other similar agreement;***

(B) ***any combination of agreements or transactions referred to in subparagraphs (A) and (C);***

(C) ***any option to enter into an agreement or transaction referred to in subparagraph (A) or (B);***

(D) ***a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), or (C), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a forward contract under this paragraph, except that such master agreement shall be considered to be a forward contract under this paragraph only with respect to each agreement or transaction under such master agreement that is referred to in subparagraph (A), (B), or (C); or***

(E) ***any security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to in subparagraph (A), (B), (C), or (D), including any guarantee or reimbursement obligation by or to a forward contract merchant or financial participant in connection with any agreement or transaction referred to in any such subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562.***

§ 101. Definitions

(26) ***The term*** **"forward contract merchant" means a ~~person whose~~** ***Federal reserve bank, or an entity the*** **business** ***of which*** **consists in whole or in part of entering into forward contracts as or with merchants in a commodity~~,~~ (as defined in section 761~~(8) of this title,~~) or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade~~,~~.**

While the "favored" status of forward contracts under the Bankruptcy Code, as evident in the "safe harbor" provisions set forth above, must be understood to be applied to good advantage for the benefit of energy creditors, the determination of what constitutes a forward contract is still an imprecise art rather than an exacting science. The statutory provisions and the caselaw which has developed under them to date leave a great deal of uncertainty (and room for creativity!) putting creditors at risk who assume too much about the legal status of their agreements.

III. CONCLUSION

Please do not give yourself a headache by getting bogged down in all of the details set forth above. Hang onto this paper as a future reference (realizing that the specifics of the law change constantly -

as evidenced by the 2005 Act, which took eight years being "born" in Congress, and the latest prospects for "bankruptcy reform" which have arisen in the context of the economic downturn) and consult with an attorney specializing in Creditors' Rights when particular issues arise in your debtor/creditor relationships. The point of this presentation is to give you the "big picture" overview, and to encourage you to remember and internalize the ten fundamental principles. If you keep a proper perspective on these anchors or axioms of bankruptcy, you will recognize opportunities for more creditor-oriented results from the bankruptcy proceedings involving your debtor/counterparties, and will have a keener insight into the overall dynamics of bankruptcy than most of your peers. You should not rely solely upon this edited educational material for your actual real-world decision-making (there are many more nuances, exceptions, and foibles not covered here), but hopefully you will now be more savvy and converse more knowledgeably with others concerned about a bankruptcy case—including your business and professional colleagues and superiors.

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