What Every Litigator Should Know Before Your Opposing Party Files for Bankruptcy Protection

Natalie Friend Wilson
Langley & Banack, Incorporated

Filing for bankruptcy protection is not uncommon when a party is involved in litigation that is not going well or when a party is involved in more than one dispute and cannot afford to continue fighting no multiple fronts. The filing of a bankruptcy petition invokes the automatic stay under 11 U.S.C. § 362, which halts most pending litigation.[1] Understanding what will happen if your opposing party files for bankruptcy protection will help you develop a more robust litigation strategy.

I. Chapter 7 v. Chapter 11 – Does it matter to you?

The Chapter under which the debtor files for bankruptcy can significantly impact your client's strategy. Generally speaking, in a Chapter 7, the debtor's assets are liquidated (often piecemeal) and the business is terminated. In contrast, the goal of a Chapter 11 case is for an operating entity to emerge.

When a Chapter 7 case is filed, a Chapter 7 Trustee is appointed automatically. Each district has a panel of Chapter 7 Trustees appointed by the Office of the United States Trustee. The Trustee is tasked with gathering and liquidating the debtor's non-exempt assets and paying creditors under the priority scheme of the Bankruptcy Code. The Chapter 7 Trustee very rarely operates the debtor's business. The notable exception is for exploration and production companies, where failing to operate the business could result in the loss of valuable assets, *e.g.*, wells held by production.

Notably, the Chapter 7 Trustee will take ownership of litigation rights. The Trustee may pursue litigation rights him- or herself, or may hire counsel to pursue them. The Trustee also has full authority to settle litigation (with Bankruptcy Court approval) or, if the Trustee deems that the claims are not valuable to the bankruptcy estate, the Trustee may abandon them.

In a Chapter 7 case, unsecured creditors are often paid very little, if anything. The Bankruptcy Petition, Schedules, and Statement of Financial Affairs will give a picture of the potential for recovery, which can inform how much your client wants to dedicate to continued litigation.

When a Chapter 11 case is filed, the debtor remains "in possession" of its assets and business. A Trustee will not be appointed unless a party party-in-interest moves for such appointment pursuant to 11 U.S.C. § 1104. A Chapter 11 Trustee will be appointed "for cause" which

[1] Certain actions, such as criminal prosecutions, some family law actions, and certain administrative actions are not stayed. *See* 11 U.S.C. § 362(b). These materials address civil litigation matters are that are subject to the automatic stay. Further, these materials presume a business-to-business dispute and do not address individual bankruptcy filings. Many of the same provisions and rules apply to individual bankruptcies (especially individual filings under Chapter 7 and Chapter 11), but additional rules and considerations apply in individual cases that are beyond the scope of this presentation.

includes "fraud, dishonesty, incompetence, or gross mismanagement of the estate" either before or after the bankruptcy filing, or if such appointment is in the best interests of the creditors, equity security holders, and other interests in the estate. A Chapter 11 Trustee steps into the shoes of the debtor and takes control over all assets, including litigation rights.

The Chapter 11 process is generally longer and more complex than a Chapter 7 case. A Chapter 11 case either be a "true reorganization" in which the debtor restructures its obligations, may obtain new or additional financing, and emerges from bankruptcy as the same entity. For example, the GM bankruptcy was a "true reorganization". A Chapter 11 debtor may also sell all or substantially all of its assets as a going concern under 11 U.S.C. § 363. The Brooks Brothers bankruptcy is an example of such a case.

II. Early Actions in a Bankruptcy Case

Some events take place early in a bankruptcy case, perhaps before your client is able to determine whether it needs to hire a bankruptcy specialist. Being familiar with these early bankruptcy events will allow you to competently advise your client until a bankruptcy practitioner is hired, if necessary.

First Day Motions

First Day Motions are so named because they are typically filed with the Bankruptcy Petition or shortly thereafter. They may also be heard on an emergency basis, sometimes within only a few days of the bankruptcy filing. Some of the most common First Day Motions are discussed below.

Motion to Employ Counsel and Other Professionals. Any "professional" paid by the estate must be employed pursuant to 11 U.S.C. § 327. For the debtor, this will include its counsel (bankruptcy counsel and any special counsel it may need to hire) and could include other professionals such as accountants, investment bankers, a Chief Restructuring Officer, and real estate brokers. The Debtor's bankruptcy counsel must be "disinterested", meaning that not only are there no conflicts of interest in the traditional sense, but they also cannot be a creditor of the debtor and they cannot "have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders" as the result of any direct or indirect relationship with or connection to any such party in interest. 11 U.S.C. § 1104.

Motion to Maintain Existing Cash Management Systems. As a general rule, debtors are required to close their pre-petition bank accounts and move all funds to a "Debtor-in-Possession Account" (DIP Account) that includes "Debtor-In-Possession" as part of the account owner's name, and includes the bankruptcy case number on all checks. The DIP Account must be at an approved financial institution. For many debtors, this is impracticable or not immediately achievable. The Debtor may therefore move the Court for authority to continue using its pre-petition accounts, usually with the proviso that they will add "Debtor-in-Possession" and the bankruptcy case number to all checks.

Additionally, checks that were issued, but not cleared prepetition, can present administrative and accounting hassles. Therefore, a motion to maintain existing cash management systems may also include a request to allow banks to honor prepetition checks upon the direction of the debtor. ‘

Motion to Obtain Post-Petition Credit. A debtor will often need position-petition credit (colloquially, a “Debtor-in-Possession Loan” or “DIP Loan”) to pay administrative and operating expenses during the pendency of the case. The conditions for such credit are set forth in 11 U.S.C. § 364. The terms of DIP Loans can be pretty onerous, including priming liens (“superpriority liens”), and may be conditioned on very aggressive milestones. The motions for approval of the DIP Loan are dense, but need to be read carefully. The motion should be accompanied by a 13-week budget that will give a preview of what the debtor expects to do over the course of the bankruptcy case. Depending on your client’s position, you may be particularly interested in looking for “carve outs” where the lender allocates a certain portion of funding to pay professionals representing the debtor or a creditors’ committee or it disclaims a lien on certain assets of the estate that are dedicated to pay junior creditors.

Critical Vendor Motion

Critical Vendor Motions have no express statutory basis, but rather, are granted under the Bankruptcy Court’s broad discretionary powers under 11 U.S.C. § 105. They are a mechanism by which the debtor pays pre-petition (unsecured) trade creditors at the outset of the case. The premise of such a motion is that, if the vendor is not promptly paid, it will cease to do business with the debtor, and the debtor will be unable to sustain operations during the pendency of the case. It is a fact-intensive inquiry and such motions are subject to close scrutiny by the Court.

Designation as a Complex Case. While not technically a “First Day Motion”, in the Southern District of Texas, if a Chapter 11 Debtor elects designation as a “complex case”, a notice of that election must be filed with the Bankruptcy Petition. All of the Texas Districts have specific procedures for complex cases, which can be found on their respective websites. If your opposing party selects this designation, you should familiarize yourself with those procedures, particularly as they pertain to actions early in the case.

First Meeting of Creditors

This meeting is also called the “341 Meeting” because it is required under 11 U.S.C. § 341. It usually takes place about 30 days after the Petition is filed, but may be extended if the debtor’s deadline to file Schedules and Statement of Financial Affairs is extended. Any party in interest can appear, attorneys are not required, even for entities that typically cannot represent themselves in court. For a Chapter 7 case, the meeting is conducted by the Chapter 7 Trustee and in a Chapter 11 case, it is conducted by a representative of the United States Trustee’s office.

At the 341 Meeting a representative of the Debtor will answer questions under oath pertaining to the assets and liabilities listed on the Schedules and Statement of Financial Affairs, the causes of bankruptcy, and the plan to exit bankruptcy. Any party in interest may ask questions within this scope. Although the normal rules of evidence and discovery do not apply, debtor's counsel will typically not allow opposing parties to pre-petition litigation to ask questions that are relevant only to that pending litigation.

Appointment of a Creditors' Committee.

Pursuant to 11 U.S.C. § 1102, "as soon as practicable" after the Petition[2] is filed, the United States Trustee "shall" appoint a committee of unsecured creditors. The Committee is made up of the seven largest unsecured creditors, if they are willing to serve. The committee members have fiduciary responsibilities to the other unsecured creditors. The committee can hire counsel (and, if necessary, other advisors) that is paid for by the bankruptcy estate. Throughout the case, they will represent the interests of the unsecured creditors. They may oppose motions for DIP Loans, object to sale procedures or sales, or object to the plan of reorganization, and following those objections, negotiate for more favorable treatment of the unsecured claims in general.

Filing a Proof of Claim. In almost every case involving unresolved pre-petition litigation, your client will need to file a proof of claim. In a Chapter 7 case, the deadline to file a proof of claim is set only if the Chapter 7 Trustee determines there will be assets available for distribution. In a "normal" Chapter 11 case, the deadline is 180 days from the date the Petition is filed. In a case under the Small Business Reorganization Act (Subchapter V of Chapter 11), the deadline is 70 days from the Petition Date.

The Proof of Claim is submitted on Official Form B410, available here: https://www.uscourts.gov/forms/bankruptcy-forms/proof-claim-0. The Proof of Claim should include proof of indebtedness, which could include the live pleading or judgment, depending on the status of the litigation. You may consider including additional proof of indebtedness, such as the underlying contract between your client and the debtor, if applicable. If you client has any type of security, you should also include proof of the security interest.

A properly filed proof of claim is prima facie evidence of the claim's validity. The debtor may object to the claim, however. Depending on the nature of the objection and the status of the pre-petition litigation, the Bankruptcy Court may resolve the objection in a contested hearing, or the parties may invoke the adversary procedures under Federal Rule of Bankruptcy Procedure 7001 *et seq.* and have a full-blown trial on the merits.

[2] The statute refers to the "order for relief". In a voluntary bankruptcy case, the order for relief is the Bankruptcy Petition. In an involuntary bankruptcy case, the debtor may consent to the bankruptcy, or after a hearing, the Court may enter an order permitting the case to go forward. The particularities of involuntary bankruptcy filings are beyond the scope of this presentation. There are reasons a litigant may want its opposing party to be in bankruptcy. For example, the appointment of a trustee could be beneficial, or the scrutiny and transparency required in the bankruptcy process may be desirable. The requirements for filing an involuntary case are found at 11 U.S.C. § 303.

Clients are always eager to know whether they can recover their attorneys' fees against a bankrupt debtor an the answer is, of course, "it depends". If attorneys' fees can be awarded as part of the underlying claim, *e.g.*, in a Texas breach of contract action, they can be awarded as part of the allowed claim. If the creditor is unsecured or undersecured, however, the ability to recover those amounts is limited. Additionally, most creditors are not able to recover the attorneys' fees incurred in the course of the bankruptcy case, *e.g.*, filing a proof of claim. Creditors *may* be able to claim attorneys' fees as an administrative expense under 11 U.S.C. § 503 if the creditor incurred "actual, necessary expenses" that make a "substantial contribution" to the chapter 11 case.

III. What happens to the Prepetition Litigation?

Removal or Modifying the Automatic Stay

When your opposing party files for bankruptcy protection, the first strategic decision your client will need to make is whether to pursue the litigation in Bankruptcy Court or try to get back into the pre-petition forum.

Removal to the Bankruptcy Court is authorized under 28 U.S.C. § 1452. Either the debtor or the creditor party can remove the case. The procedure after removal, including motion for remand is found at 28 U.S.C. § 1447. In general, a party must seek remand within 30 days of removal to the Bankruptcy Court.

When deciding whether to proceed in the Bankruptcy Court, you should consider the limited subject matter jurisdiction of Bankruptcy Courts pursuant to 28 U.S.C. § 1334(b) and the limited authority to enter final orders pursuant to 28 U.S.C. § 157. If the Bankruptcy Court does not have authority to enter a final order, it will enter a Report and Recommendation that is then reviewed by the United States District Court. Appeal then lies to the Circuit Court of Appeals. Even if the Bankruptcy Court enters a final order, there is a two-step process for appeals – first to the District Court, then to the Circuit.

Modifying the Automatic Stay. Depending on the status or subject matter of the litigation, modifying the automatic stay to allow the litigation to proceed in the original forum may be preferable. When considering a motion to modify the automatic stay, the Bankruptcy Court will consider factors like

- Efficiency
- Jurisdiction
- Jury Demand

The modification of the stay can be limited. For example, a plaintiff may agree to seek recovery only from available insurance proceeds (which are not property of the bankruptcy estate), or if a jury has rendered a verdict but judgment has not been entered, the stay can be modified solely to allow entry of judgment.

Alternative Dispute Resolution in Bankruptcy

Alternative Dispute Resolution is available in bankruptcy cases, with a few unique caveats or restrictions. In general, mediation is easier to accomplish than arbitration.

Bankruptcy Courts generally favor the use of mediation to settle disputes. If both parties agree to mediation, you may want to modify the automatic stay to permit it. If mediation is not consensual, but is required by the parties' contract, you can move to compel it. If the litigation has been removed to the Bankruptcy Court, you may also want to abate or extend any pending deadlines. Any settlement, whether it is reached through informal negotiations or formal mediation, will need to be approved by the Court. In most circumstances, this will require a motion under Federal Rule of Bankruptcy Procedure 9019 and a hearing. If the parties settle a dispute related to a matter that already requires a hearing and court approval, a separate motion may not be necessary. For example, if the parties resolve a dispute related to the approval of a sale under 11 U.S.C. § 363 or confirmation of a plan of reorganization, the compromise can be embedded in the Court's order approving the sale or confirming the plan.

Arbitration presents a more difficult question, because more authority is ceded to the arbitrator(s). The Bankruptcy Court must consider two strong federal policies – one, in favor of enforcing parties' agreements to arbitrate and the other, in favor of centralized resolution of disputes against a debtor. In the Fifth Circuit, courts must evaluate whether the cause of action arises solely from the Bankruptcy Code. If it does not, the arbitration provision should be enforced. If the cause of action does arise solely under the Bankruptcy Code, the Bankruptcy Court has considerable discretion to consider whether arbitration would be inconsistent with the purposes and policies of the Bankruptcy Code.

IV. Beware: Fraudulent Transfers & Preferential Payments

Maybe you got lucky and your client obtained a judgment or settlement shortly before the other party filed for bankruptcy protection. Don't congratulate yourself too soon, because your client may be targeted in a "clawback action". A Chapter 7 Trustee or a Debtor in Possession can bring clawback actions, including fraudulent transfer claims and preferential payments. Understanding how these clawback actions work can help you manage your client's expectations, especially if your opposing party seems perilously close to filing for bankruptcy.

Two sections of the Bankruptcy Code permit the debtor or Trustee to avoid fraudulent transfers -- under 11 U.S.C. §§ 544 & 548. Section 544 incorporates state law, *i.e.*, TUFTA, while Section 548 is unique to the Bankruptcy. The elements of a claim under either section are very similar, but not completely identical. Significantly, the lookback period under Section 548 is two years from the Petition Date for most transfers and its does not provide for recovery of attorneys' fees.

Under both sections, transfers involving both actual fraud and constructive fraud are avoidable. Additionally, the transfer does not have to be cash or other assets, but can include things like granting a security interest.

The other commonly used avoidance statute is 11 U.S.C. § 547, pertaining to preferential payments. This is a concept unique to the Bankruptcy Code, which permits the debtor or Trustee to avoid payments made within 90 days of the Bankruptcy filing (2 years for payments to insiders), that are not in the ordinary course and result in the transferee obtaining more than they would in the bankruptcy case. As with constructive fraudulent transfers, preferences do not require any bad intent on behalf of the transferee.

It is important to note that these sections only allow the *avoidance* of fraudulent transfers or preferential payments, in order to *recover* any property transferred, the debtor or Trustee must bring an action under 11 U.S.C. § 550, which can be brought concurrently with the avoidance action or within 1 year of the avoidance judgment or the time the case is closed or dismissed, whichever is earlier.

V. Conclusion

Good litigators are much like chess players; they see the whole board, understand the moves the opposing party *could* make, and knowing how to counter a variety of maneuvers. Bankruptcy is a very complex, and often fast-paced, are of the law, so it is almost always advisable to hire experienced bankruptcy counsel if your client is going to be substantially involved in a bankruptcy case. But, understanding how a bankruptcy case could affect your client will help you develop a better litigation strategy and help your client make more informed decisions. Knowing what happens early in a bankruptcy case will help your client protect their interests until bankruptcy counsel is hired, if necessary.

If you have questions, please feel free to reach out to me at nwilson@langleybanack.com or (210) 736-6600.