



Before You File

How to Plan,
Questions to Ask,
and Pitfalls to Avoid

*Presented by Andrew Layden and Esther McKean
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Presented by:



Esther McKean
Akerman LLP



Andrew Layden
BakerHostetler

Bankruptcy Chapters

- Chapters under the Bankruptcy Code
 - Chapter 7 – Liquidation
 - Chapter 9 – Municipal
 - **Chapter 11 – Reorganization**
 - **Subchapter 5 – Small Business Debtors**
 - Chapter 12 – Farmers/Fishermen
 - Chapter 13 – Individual Reorganization
 - Chapter 15 – Recognition of Foreign Bankruptcy Proceeding

Parties to Bankruptcy

- Debtor
- U.S. Trustee
- Chapter 7 Trustee
- Chapter 11 Trustee / Examiner
- Creditor's Committee (Chapter 11)
- Creditors (secured, unsecured, lessors)
- Professionals
- Equity Holders
- Governmental Entities

How did you get here? (1 of 2)

- As an initial matter, it is important for the bankruptcy practitioner to gain an objective understanding – from both a business and financial perspective - of how the debtor got into its current situation.
 - Single unexpected event;
 - Long-term business issues;
 - Aggressive creditor activity;
 - Mismanagement or fraudulent activity; or
 - Key creditors have lost faith in debtor's management team
- Often a combination of many factors

How did you get here? (2 of 2)

- *Practice Pointers:*
- Confidence in Management
 - Consider whether retaining credible professional advisors in addition to bankruptcy counsel, such as a financial advisor, CRO, or independent directors, or replacing key decision makers could restore confidence in debtor's management team, which could make a non-bankruptcy solution, such as a forbearance agreement or third party re-financing, viable.
- Key Financial Documents
 - Obtain and review key financial documents early in the process. Those documents vary by case and industry, but generally include tax returns, financials (P&L, Balance Sheet, Cash Flow Statement), loan documents for primary secured creditor(s), entity charts, and organizational charts. Review or have the debtor prepare budgets and cash flow projections for the coming months.

Asking the Right Questions – the Client Interview

- Co-Debtors
- Liens
- Cross-collateralization
- Relationships with Creditors
- Insider Issues
- Intercompany Transfers
- Employee Issues
- Regulatory Issues
- Cash needs
- Vendor Issues

Where Are You Going: Reorganize or Liquidate?

- Reorganization - Generally four options:
 1. Out of Court Workout
 2. Conventional Chapter 11
 3. Pre-negotiated Chapter 11
 4. Pre-packaged Chapter 11
- Liquidation – Generally six options:
 1. Chapter 11
 2. Chapter 7
 3. Assignment for Benefit of Creditors
 4. State Court Receivership
 5. Dissolution
 6. UCC give-back / foreclosure

SBRA?

- Is the Debtor eligible for treatment as a Small Business Debtor?
 - Debt ceiling raised from \$2,725,625 to \$7,500,000
 - Key features:
 - No creditors' committee
 - No competing plans
 - No requirement of a separate Disclosure Statement
 - No quarterly fees to the U.S. Trustee
 - No absolute priority rule
 - No requirement of at least one impaired consenting class
 - Debtor not required to pay all post-petition administrative expense claims on the plan's effective date and may instead pay over 3-5 years

Who is the Client?

- Debtors vs. Insiders
 - Due to the numerous situations in which the interests of the debtor and its owners or persons in control of the debtor diverge, it is generally not advisable for a firm to represent both the debtor and its insiders.
 - Examples of such situations include: (i) the debtor holding claims against insiders, including Chapter 5 causes of action or state-law based claims such as breach of fiduciary duty or successor liability; (ii) recharacterization issues relating to loans from insiders; (iii) the participation of insiders or parties related to insiders as potential buyers of the debtor's assets; and (iv) the inclusion in a Chapter 11 plan of bar orders or third party releases in favor of insiders. It is important that the debtor's insiders understand from the beginning that you represent the debtors, and the ramifications of that representation, including that the insiders likely need individual counsel.

Can You Represent Them? (1 of 2)

- Bankruptcy Code Requirements
 - Broadly speaking, Section 327(a) imposes two requirements on retention of professionals by a DIP. The professional must be: (1) disinterested, as defined in Section 101(14); and (2) not hold or represent any interest adverse to the estate. To hold or represent an interest adverse to the estate generally means: (1) “to hold or assert any economic interest that would tend to reduce the value of the bankruptcy estate or that would give rise to an actual or potential dispute in which the estate is a rival claimant; or (2) to possess a predisposition under circumstances that render such predisposition a bias against the estate.”
 - Fed. R. Bankr. P. 2014 requires that an application to employ a professional be accompanied by a verified statement which “setting forth the person’s connection with the debtor, creditors, and other party in interest...” In determining whether there has been compliance with Rule 2014, “it is the degree of completeness of the disclosure, rather than the applicant’s subjective intent or state of mind with respect to the disclosure that is material.”

Can You Represent Them? (2 of 2)

- *Practice Pointers*
- **Conflict Check**
 - As an initial matter, prospective counsel for the debtor should conduct a conflict check as soon as possible. At a minimum, this initial conflict check should include: (i) the debtor; (ii) its owners and control persons; (iii) secured creditors; and (iv) key unsecured creditors (e.g. the top 20). In most cases, this initial conflict check will later be supplemented and form the basis for the Rule 2014 statement.
- **Pre-Bankruptcy Payments**
 - It is generally advisable to obtain a pre-petition advance payment retainer and make timely draws against the retainer for pre-petition work to avoid receiving a disqualifying preferential payment. If you do not obtain a pre-petition retainer, ensure the debtor remains current on payments to your firm pre-petition, or waive the claim against the debtor prior to retention under Section 327(a).
- **Rule 2014 Statement**
 - Often, the use of conflicts counsel, and/ or the use of an ethical wall may be sufficient to resolve conflicts that are identified. However, it can be difficult or impossible to resolve a conflict that was not disclosed prior to counsel's retention.

Pre-Filing Considerations for Debtor's Management (1 of 2)

- Standard of Conduct (State Specific- Assumes Delaware Corporation)
 - The board's power to act on the corporation's behalf is governed by the directors' fiduciary relationships with the corporation and its shareholders, which imparts on the directors duties of care and loyalty. The duty of care generally consists of an obligation to act on an informed basis. The duty of loyalty generally requires the board and its directors to maintain, in good faith, the corporation's and its shareholders' best interests over any other interests.
- Business Judgment Rule
 - Significantly, the business judgment rule generally only applies only in the context of a valid exercise of business judgement by disinterested directors. Potential debtors should be especially vigilant in screening directors from transactions in which they are interested, especially considering the increased rights of creditors to challenge board decisions in the event of insolvency

Pre-Filing Considerations for Debtor's Management (2 of 2)

- With respect to a solvent corporation, the residual economic stakeholders are the stockholders. Thus, the standard of conduct requires that directors seek prudently, loyally, and in good faith to manage the business of a corporation for the benefit of its shareholder owners.
- Upon insolvency, the board entity continues to have a fiduciary duty to the entity, but it may be enforced by all constituencies including secured and unsecured creditors.
- While earlier cases discussed the "zone of insolvency," current cases have retreated from the idea that there is a duty owed to creditors (and not shareholders) in the zone of insolvency.

Where Should the Debtor File? (1 of 3)

- Proper Venue (28 U.S.C. § 1408).
 - Section 1408(a) provides two potential venue choices for a debtor filing a bankruptcy case: (1) the location of debtor's the domicile, residence, principal place of business in the United States, or principal assets in the United States; or (2) the district in which there is a pending case under title 11 concerning the debtor's affiliate, general partner, or partnership.
- Accordingly, unless venue is based on a currently-pending case under 1408(a)(2), that leaves four possible statutory bases for a proper venue
 - (1) **Domicile**. Courts have interpreted "domicile" to mean state of incorporation;
 - (2) **Residence**. Courts generally find this inapplicable to entities, because it refers only to the place where a natural person lives;
 - (3) **Principal Place of Business**. The location of a corporation's principal place of business for bankruptcy venue purposes refers to the place where the corporation's officers direct, control and coordinate the corporation's activities.
 - 4) **Principal Assets**. The location of the debtor's principal assets is a question of fact.

Where Should the Debtor File? (2 of 3)

- Transfer of Venue (28 U.S.C. § 1412).
 - Even where a case is originally filed in a proper venue, the case may be transferred “in the interest of justice or for the convenience of the parties” under Section 1412 and Fed. R. Bankr. P. 1014(a)(1).
 - A movant seeking transfer of a bankruptcy case to a different venue bears the burden of proof, and that burden must be carried by a preponderance of the evidence. The district where the underlying bankruptcy case is pending “is presumed to be the appropriate district for hearing and determination of a proceeding in bankruptcy.” Additionally, a debtor’s choice of forum is entitled to great weight if venue is proper under Section 1408.

Where Should the Debtor File? (3 of 3)

- Jurisdiction-Specific Issues:
 - Critical vendors
 - Appropriate DIP financing terms
 - Standard for substantive consolidation
 - Case law on 363 sales outside the Chapter 11 plan context and the circumstances under which such sales constitute *sub rosa* plans
 - Third party release
- Local Rules

Filing and First Day Motions (1 of 2)

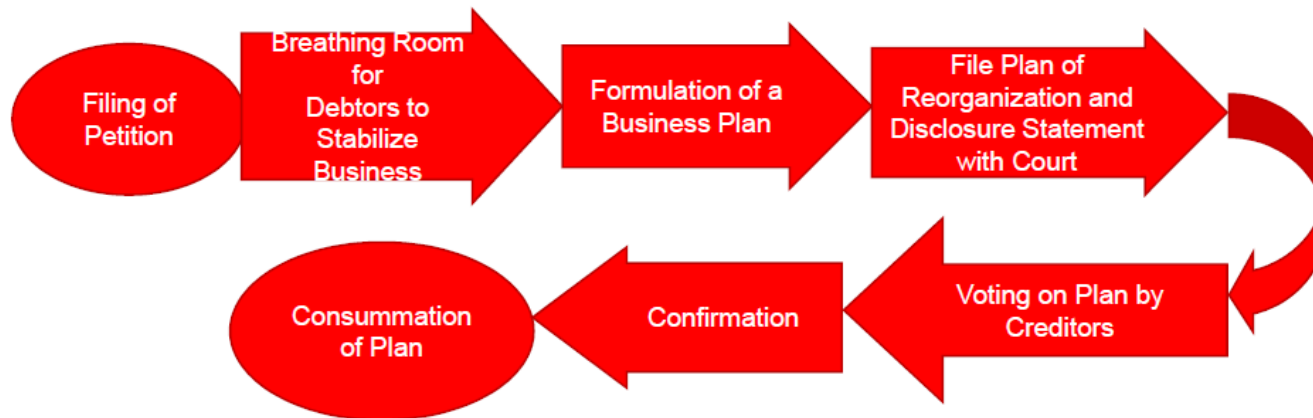
- Timing
 - Seasonality to debtor's business
 - Employee wages
- Authority to File
 - Well in advance of a filing, counsel should analyze the debtor's relevant formation and operational documents in order to identify what action is necessary to authorize the filing, and confirm that the debtor's representatives have the power to authorize it.
- Bad Faith
 - Consider and anticipate bad faith challenges to the filing of the petition. The Eleventh Circuit's *Phoenix Piccadilly* decision held that a debtor's bad faith in filing its petition for relief constitutes cause of dismissal of the bankruptcy case. There is a substantial body of case law interpreting and applying *Phoenix Piccadilly*. Be aware of the potential applicability of this case law to your facts before you file.

Filing and First Day Motions (2 of 2)

- First Day Motions
 - Determining what first day motions are needed, the nature of the relief that will be sought in each motion, and the deadline by which the debtor requires such relief are obviously significant tasks that should be considered carefully, and where practicable, well in advance of the filing.
 - Keep in mind - First day motions are the debtor's first opportunity to begin establishing creditability with the Court through factual accuracy, providing proper notice to all affected parties, and reasonably limiting the relief sought at the first day hearing.
 - Checklist of common first day motions included in materials
- Operating in Chapter 11
 - US Trustee reporting requirements
 - “Ordinary Course of Business”
 - Broad Scope of Permissive Discovery

Chapter 11 Flow Chart

Reorganization Process



Key Concepts

- Bankruptcy Estate
- Automatic Stay
- Executory Contracts and Unexpired Leases
- Claims Process
- Distribution Scheme
 - Secured
 - Priority Unsecured (including administrative expenses)
 - General Unsecured Creditors
 - Equity
- Avoidance Actions (fraudulent transfers; preferential transfers)