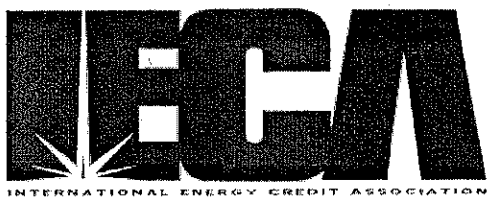
Never Trust the Trustee: A Survey of Typical Bankruptcy Disputes Between Trustees and Creditors



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Never Trust the Trustee: A Survey of Typical Bankruptcy Disputes Between Trustees and Creditors

by D. Brent Wells

I. INTRODUCTION

Is the Trustee friend or foe, fish or fowl? It all depends, since the Trustee has goals and responsibilities different from any particular creditor's interest in collecting its claim or protecting its perceived rights. This presentation will provide an overview of bankruptcy scenarios where the Trustee's interests and those of particular creditors can be - and often are - at odds. Topics to be covered include adequate protection, executory contracts, proof of claim litigation, Trustee "strong arm" powers, and preferences. Hear about these issues from the perspective of an experienced Creditors' Rights Specialist who has often gone to war with the Trustee!

II. WHO IS THIS "PERSON?"

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. By virtue of §1107(a) of the Bankruptcy Code, 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.

The Trustee is the sole representative of the bankruptcy Estate, represents all the creditors of the estate generally, and is entitled to administer the property of the estate wherever located, including the debtor's pre-bankruptcy lawsuits or causes of action. The Trustee does not represent the debtor and does not owe the debtor any fiduciary duty. **Since the Trustee inherits existing causes of action and lawsuits in favor of the debtor on the bankruptcy petition date, any such litigation between the debtor and one of its creditors will potentially transform in bankruptcy to a dispute between the creditor and the Trustee.** A commonly-occurring mistake is for the debtor to attempt to assert causes of action against third-parties that only properly belong to the Trustee. All of the debtor's pre-bankruptcy rights of action devolve upon the Trustee. The debtor is not the proper party-plaintiff when the Trustee rather than the debtor is vested with the right to maintain the cause of action.

With or without Court approval, the Trustee or Debtor-In-Possession may prosecute or may enter an appearance and defend any pending action or proceeding by or against the debtor, or commence and prosecute any action or proceeding in behalf of the estate before any tribunal. The Trustee, as representative of the estate, has the exclusive capacity to sue and be sued on behalf of the estate, and is charged by law with representing the interest of the estate against third-parties claiming adversely to it.

A Trustee is empowered to commence actions on behalf of the Estate, falling into two categories: (1) those brought by the Trustee as successor to the debtor's interest included in the estate, *i.e.* standing in the shoes of the debtor; and (2) those brought under one or more of the Trustee's special bankruptcy powers, *e.g.* preference avoidance, "strong-arm" powers. A Trustee must also be named as a party-Defendant in an action seeking to proceed against the assets of the estate, *e.g.* lift-stay to foreclose on secured creditor collateral.

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.

Trustees must meet requirements of eligibility that include: (1) competence, (2) residence in the judicial district or an adjacent district, and (3) disinterestedness, as well as lack of any adverse interest. The Trustee is required to file a qualifying bond to assure faithful performance and to indemnify estates for any loss which might be sustained as a result of misfeasance or malfeasance.

Bankruptcy Trustees are immune from personal liability for acts performed as a matter of business judgment, and in accordance with statutory or other duty or pursuant to Court order. However, personal liability will attach to a bankruptcy Trustee when the Trustee has negligently failed to discover his agent's negligence, negligently obtained a Court order, or negligently carried out an order that he knew or should have known was wrongly procured.

Not to be confused with the Bankruptcy Trustee is the office of the United States Trustee. The United States Trustee is an adjunct of the executive branch of government, not the judicial, with broad administrative and supervisory powers to oversee the administration of the bankruptcy system as a whole in a given federal District. Bankruptcy Trustees in individual cases are appointed by the United States Trustee, not the Bankruptcy Court, from panels of pre-qualified Trustees. By analogy to the criminal justice system, the U.S. Trustee is more like the prosecutor than the Judge. The United States Trustee is intended to oversee the panel Trustees and be a watchdog of the public interest, with has standing to intervene in any particular bankruptcy proceeding as necessary to meet this general administrative end.

A. Chapter 7

Chapter 7 bankruptcy ("straight bankruptcy"), filed under the provisions of Section 701 to 766 of the Bankruptcy Code, contemplates the traditional liquidation of the debtor's assets (analogous to a probate administration). The Trustee collects the non-exempt property of the debtor, converts that property to cash, and, after satisfying administrative expenses and paying priority claims, distributes the remaining cash to the creditors. **The Chapter 7 Trustee thus wants to promptly exercise dominion and control over all the Estate assets, including property of the debtor that may be in the hands of a creditor on the bankruptcy petition date.** The debtor gives up all of the non-exempt property owned at the time of filing the bankruptcy petition in the hope of obtaining a discharge, releasing the debtor from any further liability for pre-bankruptcy debts. In Chapter 7, the Trustee (1) collects the property of the estate, (2) challenges pre-bankruptcy transfers,

(3) sells the property of the estate, (4) objects to creditors' claims, and (5) if necessary, objects to discharge.

The duties of the Chapter 7 Trustee are prescribed by Bankruptcy Code Section 704(a):

§ 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;

(9) make a final report and file a final account of the administration of the estate with the court and with the United States trustee;

(10) if with respect to the debtor there is a claim for a domestic support obligation, provide the applicable notice specified in subsection (c);

(11) if, at the time of the commencement of the case, the debtor (or any entity designated by the debtor) served as the administrator (as defined in section 3 of the Employee Retirement Income Security Act of 1974) of an employee benefit plan, continue to perform the obligations required of the administrator; and

(12) use all reasonable and best efforts to transfer patients from a health care business that is in the process of being closed to an appropriate health care business that—

(A) is in the vicinity of the health care business that is closing;

(B) provides the patient with services that are substantially similar to those provided by the health care business that is in the process of being closed; and

(C) maintains a reasonable quality of care.

B. Chapter 13

Chapter 13 is a form of rehabilitation proceeding available to an individual, who has regular income, and has fixed unsecured debts of less than $336,900.00 and fixed secured debts of less than $1,010,650.00. Among the advantages of Chapter 13 to an individual are rehabilitation, which carries less stigma, and may have less impact on future creditworthiness, than liquidation, and a streamlined procedure with a minimum of Court supervision.

The Courts are divided as to whether the Chapter 13 Trustee or the Chapter 13 debtor is the is the "true representative of the estate" and enjoys the Trustee's "strong-arm" powers. Thus, the Chapter 13 Trustee does not exclusively exercise all of the Trustee's rights and powers under the Code: pursuant to Code Section 1303, the debtor has the rights and powers of use, sale, or lease subject to adequate protection; pursuant to Code Section 1304, a Chapter 13 debtor engaged in business may use property of the estate and incur debt/obtain credit in the ordinary course; pursuant to Code Section 1306(b), the debtor may possess the estate property; and pursuant to Code Section 1322(b)(7), the debtor may propose in a Chapter 13 plan to assume or reject executory contracts including unexpired leases.

C. Chapter 11

Chapter 11 bankruptcy provides procedures for Court-supervised reorganization and continuation of the debtor, not liquidation. Under a plan approved by the Bankruptcy Court, creditors look to future performance of the debtor, not the property at the time of the initiation of the bankruptcy, to address their claims. The debtor retains its assets and remains "in possession," acting as its own Trustee, unless there are reasons, such as fraud or mismanagement or failure to comply with legal requirements, which necessitate appointment of an independent Trustee. When a Trustee is appointed in a Chapter 11 proceeding, he or she is assigned some, but not all, of the duties of the Chapter 7 trustee. One of the duties not incorporated in Chapter 11 is the duty to oppose discharge if advisable.

§ 1106. Duties of trustee and examiner.

(a) A trustee shall—

(1) perform the duties of a trustee, as specified in paragraphs (2), (5), (7), (8), (9), (10), (11), and (12) of section 704;

(2) if the debtor has not done so, file the list, schedule, and statement required under section 521(1) of this title;

(3) except to the extent that the court orders otherwise, investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formation of a plan;

(4) as soon as practicable—

(A) file a statement of any investigation conducted under paragraph (3) of this subsection, including any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate; and

(B) transmit a copy or a summary of any such statement to any creditors' committee or equity security holders' committee, to any indenture trustee, and to such other entity as the court designates;

(5) as soon as practicable, file a plan under section 1121 of this title, file a report of why the trustee will not file a plan, or recommend conversion of the case to a case under chapter 7, 12, or 13 of this title or dismissal of the case;

(6) for any year for which the debtor has not filed a tax return required by law, furnish, without personal liability, such information as may be required by the governmental unit with which such tax return was to be filed, in light of the condition of the debtor's books and records and the availability of such information;

(7) after confirmation of a plan, file such reports as are necessary or as the court orders; and

(8) if with respect to the debtor there is a claim for a domestic support obligation, provide the applicable notice specified in subsection (c).

III. ADEQUATE PROTECTION

Section 361 of the Bankruptcy Code contemplates that parties will request the Court to determine whether or not the interest of a creditor or other non-bankrupt party in property is "adequately protected" when the Trustee (including a Chapter 11 Debtor-In-Possession) is using, selling, leasing, or borrowing against the property, or when the entity is otherwise stayed from enforcing its interest. The competing parties may agree on adequate protection, the creditor may request particular protection, or the Trustee (including a Chapter 11 Debtor-In-Possession) may propose protection that it believes is adequate. At least theoretically, the burden is on the Trustee to supply adequate protection, which may be accomplished by (1) periodic payments, (2) additional or replacement liens, or (3) such other relief as will result in the realization of the "indubitable equivalent" of the creditor's interest. **The fundamental conflict between the Trustee and the creditor with an interest in property (such as a lien) is that the Trustee wants the property for the Estate in competition with the creditor's intention to have the property or its value. Thus, the Trustee will look for every means to undermine or defeat the creditor's perceived property right. Even where a property right is acknowledged, there is often a dispute about how to assess its "indubitable equivalent," whether in terms of value or benefits.**

A. Lifting the Stay

1. What is the Automatic Stay?

An immediate benefit to the debtor in filing a voluntary 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 (whether voluntary or involuntary). 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 its 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.

2. Lifting the Stay

The automatic stay is not, however, a completely impenetrable obstacle. A party-in-interest (often 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. The motion to lift the stay is filed (along with a filing fee) under the authority and constraints of Bankruptcy Code §362(d) and Bankruptcy Rule 4001. **Because the Trustee "owns" any equity over and above the creditor's secured collateral interest, the Trustee is motivated to dispute the equity issue, both in terms of maximizing the property's value and minimizing the creditor's lien therein.**

§ 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~~

(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) *or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later*—

(A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

(B) the debtor has commenced monthly payments *that*—

(i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property* to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien)~~, which payment~~; *and

(ii)* are in an amount equal to interest at ~~a current fair market rate~~ *the then applicable nondefault contract rate of interest* on the value of the creditor's interest in the real estate*;

Rule 4001. Relief from Automatic Stay; Prohibiting or Conditioning the Use, Sale, or Lease of Property; Use of Cash Collateral; Obtaining Credit; Agreements.

(a) Relief from Stay; Prohibiting or Conditioning the Use, Sale, or Lease of Property.

***(1) Motion.* A motion for relief from an automatic stay provided by the Code or a motion to prohibit or condition the use, sale, or lease or property pursuant to §363(e) shall be made in accordance with Rule 9014 and shall be served on any committee elected pursuant to §705 or appointed pursuant to §1102 of the Code or its authorized agent, or, if the case is a chapter 9 municipality case or a chapter 11 reorganization case**

and no committee of unsecured creditors has been appointed pursuant to §1102, on the creditors included on the list filed pursuant to Rule 1007(d), and on such other entities as the court may direct.

The creditor moving for relief from the automatic stay has the practical challenge to persuade and move the Court's discretion.

The burden of proof on a motion to lift or modify the automatic stay is a shifting one. Section 362(d)(1) requires an initial showing of cause by the movant, while Section 362(g) places the burden of proof on the debtor for all issues other than "the debtor's equity in property," 11 U.S.C. § 362(g)(1). *See 2 Collier on Bankruptcy 362.10,* at 362-76. If the movant fails to make an initial showing of cause, however, the court should deny relief without requiring any showing from the debtor that he is entitled to continued protection.

In re Sonnax Industries, Inc., 907 F2d 1280 (2d Cir. 1990).

Under the procedural mechanisms of Bankruptcy Code §362(e), the stay expires 30 days after filing of the Motion, unless the Court continues it; and the stay terminates 60 days after the Motion, unless the Court renders a final decision. The final hearing shall be concluded not later than 30 days after the conclusion of the preliminary hearing.

§ 362. Automatic stay.

(e)*(1)* Thirty days after a request under subsection (d) of this section for relief from the stay of any act against property of the estate under subsection (a) of this section, such stay is terminated with respect to the party in interest making such request, unless the court, after notice and a hearing, orders such stay continued in effect pending the conclusion of, or as a result of, a final hearing and determination under subsection (d) of this section. A hearing under this subsection may be a preliminary hearing, or may be consolidated with the final hearing under subsection (d) of this section. The court shall order such stay continued in effect pending the conclusion of the final hearing under subsection (d) of this section if there is a reasonable likelihood that the party opposing relief from such stay will prevail at the conclusion of such final hearing. If the hearing under this subsection is a preliminary hearing, then such final hearing shall be concluded not later than thirty days after the conclusion of such preliminary hearing, unless the 30-day period is extended with the consent of the parties in interest or for a specific time which the court finds is required by compelling circumstances.

Nuggets of wisdom from Chapter 7 Bankruptcy Trustee Daniel J. Goldberg of the Eastern District of Texas: "When it comes to the lifting of the stay, the first issue that a Trustee looks at is the question of the validity of the lien and was it properly perfected. Can the Trustee set the lien aside and bring the property into the Estate? The second question, assuming the lien is valid, is the question of equity. Is there any equity in the property for the Estate and how can that equity be maximized for the Estate? Can the equity be sold to a third-party? Can it be sold to the secured creditor? Can an objection to the Motion be used to cut a beneficial deal with the creditor or someone else?"

B. Use, Sale or lease of Property

The Trustee may move the Court for use, sale, or lease of the debtor's property (free and clear of liens or other legal impediments) in which a third-party (such as a spouse, co-owner, or creditor) has an interest; or, the third-party may initiate the approach to the Court for scrutiny and control over such use, sale, or lease. Generally, the bankruptcy Trustee is empowered to use, sell, or lease property of the bankruptcy estate in the ordinary course of business.

§ 363. Use, sale, or lease of property.

(c)(1) If the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

The Trustee is motivated to want as little imposition on the Estate's use, sale, or lease of property as possible. Thus, a creditor with an interest in property will engender conflict by asking for "adequate protection" that weighs against or encumbers the Trustee's use, sale, or lease of Estate assets.

IV. EXECUTORY CONTRACTS

Executory contracts are those, such as leases in mid-term, in which performance remains due to some extent on both sides. For example, a land sale "earnest money" contract is executory in nature when some performance remains due by both parties, and it is irrelevant whether it is the seller or the purchaser who files for bankruptcy protection. Upon motion to and approval by the Court, the bankruptcy Trustee may reject an executory contract that is considered to be burdensome to the estate; assume and retain an executory contract that is considered to be beneficial to the estate; or assume and assign an executory contract that would be valuable to a third-party, and therefore, contribute value to the estate.

Rejection is a breach of the executory contract as of the petition date, giving the non-bankrupt party an unsecured claim. Assumption requires curing arrearages and future compliance with the contract; in other words, assumption includes both the benefits and burdens of the executory contract. *O'Neill v. Continental Airlines, Inc.*, 981 F.2d 1450 (5th Cir. 1993).

§ 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.

Assignment requires curing arrearages, as well as "adequate assurance of future performance," but the debtor is absolved from further liability after the assignment. The timing of assumption or rejection of executory contracts is a function of whether the case is a "straight bankruptcy" or a rehabilitative proceeding. A Bankruptcy Court may grant multiple extensions of the time within which a lessee must assume or reject its leases of non-residential real property, so long as a motion to extend is brought prior to the expiration of the period previously extended, and as long as there is "cause" for granting the extension. *In re American Healthcare Management, Inc.*, 900 F.2d 827, 22 C.B.C.2d 1740 (5th Cir. 1990).

Generally, the obligations of a contract assumed in bankruptcy are evaluated under State law. *In re Eagle Bus Mfg., Inc.*, 148 Bankr. 481 (S.D. Tex. 1992). However, one very significant feature of Section 365 of the Bankruptcy Code is that it invalidates and renders ineffectual provisions in an executory contract 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 are still very commonly used, do not mean what they say.

With rare exceptions (such as a "forward contract"), creditors do not get to decide whether executory contracts will be performed or aborted. Since the Trustee has the power to decide whether to seek Court approval to assume, reject, or assign executory contracts, creditors who are counterparties to such contracts on the petition date will have a "friend" in the Trustee when an early decision is made to assume, and an "enemy" when the decision is to reject. Such creditors will often be frustrated when the decision to assume or reject is delayed by the Trustee requiring creditor initiative to compel assumption or rejection by a deadline date.

Nuggets of wisdom from Chapter 7 Bankruptcy Trustee Daniel J. Goldberg of the Eastern District of Texas: "Should the executory contract be affirmed or rejected? How can the Trustee use his powers to bring in the most money/benefit for the Estate? Usually it is by rejection of the contract, reselling any affected property, and giving the other party an unsecured claim in the Estate."

V. PROOFS 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.

A Chapter 7 or 11 debtor is required to file its schedules and statement of financial affairs within 15 days of the commencement of the bankruptcy case, unless the Bankruptcy Court entertains a motion to grant an extension. A Chapter 13 debtor must file a Chapter 13 Statement; if he is engaged in business, he must prepare the appropriate statement of financial affairs. It is common for the schedules and statement of financial affairs or Chapter 13 Statement to be filed with the petition. In the larger bankruptcy cases, time extensions are frequently and sometimes repetitively sought due to the complexity or size of the debtor and property of the estate. The schedules and statement of financial affairs or Chapter 13 Statement are the second source of public information which a creditor may consult to determine whether its claim is recognized.

In many cases, it may be impractical for the typical creditor to review these filed documents. Geographic distances, the size of the claim, and access to files may make the cost of the effort too expensive for the average creditor, given the level of return to be expected in bankruptcy (however, online access to PACER at http://pacer.psc.uscourts.gov/ has vastly improved creditor options for reviewing filed documents). Besides, 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.

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. Follow the statutory form.

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.

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.

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.

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.

The partially secured creditor should also file a Proof of Claim to preserve the right to treatment as an unsecured creditor to the extent that a deficiency exists in the lien itself or in the value of the collateral. The Bankruptcy Code is tough on secured creditors, as debtors and Trustees are granted extensive avoidance powers to set aside liens. To the extent that a lien is avoided or subordinated, a debtor might argue successfully that failure to file a Proof of Claim to preserve a prospective unsecured claim precludes the formerly secured creditor from participating as an unsecured creditor.

The Trustee wants to defeat as many claims as possible, leaving more assets available for distribution to the universe of claims that survive. Special attention is given to trying to defeat secured claims, because by taking property away from secured creditors, the Trustee is like Robin Hood, with more assets to administer and to distribute to the unsecured.

Nuggets of wisdom from Chapter 7 Bankruptcy Trustee Daniel J. Goldberg of the Eastern District of Texas: "Are the Proofs of Claim supported by proper documentation? Are they timely filed? Are they properly categorized by the creditor (priority, secured, unsecured)? Are they liquidated to specific money amounts, or are damages only estimated, subject to conditions or subsequent events, which invites objection litigation for the Trustee to try to bring the amount down?"

VI. "STRONG ARM" POWERS

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 or security interest 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.

Section 544 puts the Trustee and any affected creditor directly into conflict because it provides the means for the Trustee to take away the creditor's perceived property right.

Nuggets of wisdom from Chapter 7 Bankruptcy Trustee Daniel J. Goldberg of the Eastern District of Texas: "Is there really a lien and has it been properly perfected? How much is it worth to the creditor not to litigate the issue? Are there claims or crossactions to be urged by the Trustee? For example, can a claim for usury be made, where the value of the property taken away by strong-arm analysis can be added to the calculation of unlawful or over-reaching interest relative to the creditor's resulting unsecured principal claim?"

VII. PREFERENCE RECOVERY

The Trustee is inherently antagonistic to any creditor who has received pre-bankruptcy payments or transfers on the eve of the bankruptcy filing which can be characterized as preferential under the Bankruptcy Code's avoidance provisions and recovered for the Estate by disgorgement from the creditor.

Common law does *not* condemn a preference. Under common law, a debtor--even an insolvent debtor--may treat certain creditors more favorably than other similar creditors. Although D owes X, Y, and Z $1,000 each, D may pay X's claim in full before paying any part of Y's claim or Z's claim.

Bankruptcy law *does* condemn *certain* preferences. A Congressional report that accompanied a draft of the original 1978 Bankruptcy Code explained the rationale for such a bankruptcy policy as follows:

> "The purpose of the preference section is two-fold. First, by permitting the trustee to avoid pre-bankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out of a difficult financial situation through cooperation with all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally." House Report 95-595 at 117-78.

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.

A. Contemporaneous Exchange

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

1. 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

2. 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.

B. Ordinary Course of Business

Section 547(c)(2) of the Bankruptcy Code has been revised by the 2005 Bankruptcy Reform Act and now precludes the avoidance of a transfer to the extent such transfer was:

1. in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; and

EITHER

2. made in the ordinary course of business or financial affairs of the debtor and the transferee;

OR

3. made according to ordinary business terms.

The former version of this defense had an "and" in place of the "or" above, necessitating proof of all three elements. Now, the creditor must prove only two elements, and can prevail on the defense by either focusing on the "subjective" specifics of the immediate relationship of the parties, or on the "objective" industry standard for the type of business under scrutiny. "The purpose of this exception is to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." H.R.Rep. No. 595, 95th Congress, 1st Session 373 (1977).

C. Subsequent New Value Defense

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–

1. not secured by an otherwise unavoidable security interest; and

2. 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). Section 547(c)(4) is intended to encourage creditors to deal with troubled businesses in the hope of rehabilitation.

D. Statute of Limitations

Bankruptcy Code § 546(a)

(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.

E. Forward Contracts

In much the same way that secured creditors are a "favorite" of bankruptcy law, forward contracts and forward contract merchants also receive "favored" or "safe harbor" 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 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 transactions.

Bankruptcy Code § 101(25) and (26)

(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 combination 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.

(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.**

The determination of what constitutes a forward contract is still a somewhat imprecise art rather than an exacting science. The statutory provisions and the caselaw which has developed under them to date still leave uncertainty (and room for creativity!) putting creditors at risk who assume too much about the legal status of their agreements.

One of the most encouraging of the reported decisions originated in Bankruptcy Court in Houston and was affirmed on appeal to the federal Fifth Circuit, namely, *In re Olympic Natural Gas Company,* 258 B.R. 161, 164-65 (Bankr. S.D. Tex. 2001), *aff'd* 294 F. 3d 737 (5th Cir. 2002). This case "clarified" that physical delivery contracts for sale of natural gas could qualify for "safe harbor" treatment, notwithstanding that they were not "financial" or "derivative" in nature.

However, not all Bankruptcy Courts have embraced forward contracts and forward contract merchants with open arms. In *Aurora Natural Gas, LLC, v. Texas Eastern Transmission Corporation, et al.*, 316 B.R. 481 (Bank. N.D. Tex. 2004), Aurora's Chapter 7 Trustee brought an adversary proceeding to avoid a pre-petition payment to Duke Energy Field Services. Duke moved for summary judgment under Section 546(e) of the Bankruptcy Code set forth above. The Bankruptcy Court denied Duke's motion because it held that a

genuine issue of material fact existed to be tried in a full-blown evidentiary proceeding concerning whether Duke acted as a forward contract merchant or instead as a debt collector when it engaged in activities to collect amounts owed to it by Aurora. The Bankruptcy Court suggested that if Duke was acting as a debt collector, and not a forward contract merchant, then Duke may not be entitled to "safe harbor" protection.

This decision came shortly after the holding in *Mirant Americas Energy Marketing, L.P. v. Kern Oil & Refining Co.*, 310 B.R. 548 (Bank. N.D. Tex. 2004), where the Bankruptcy Court rejected Kern Oil & Refining Company's suggestion that it was entitled to be treated as a forward contract merchant simply because it entered into a forward contract in connection with its business.

The Delaware Bankruptcy Court's decision in *In re Borden Chemicals and Plastics Operating Limited Partnership; BCP Liquidating LLC vs. Bridgeline Gas Marketing, LLC,* 336 B.R. 214 (U.S. Bankruptcy Ct. Dist. Dela. 2006), gave a great deal of encouragement to energy industry creditors. The *Borden* Court held that a NAESB supply agreement qualified as a "forward contract;" the payments under scrutiny were "settlement payments" made pursuant to the forward contract; the parties were "forward contract merchants;" and thus "safe harbor" protection from bankruptcy prohibitions applied.

The latest on this subject was the Fourth Circuit Court of Appeals opinion issued February 11, 2009 in *In re National Gas Distributors, LLC,* 556 F.3d 247 (4th Cir. 2009). It is a great opinion for energy industry creditors, thanks in large measure to the International Swap Dealer Association's participation as a "friend of the Court" in the briefing process. The Court construed the Bankruptcy Code definition of "swap agreement,"amended by the 2005 Bankruptcy Reform Act, which includes a concept of "forward agreement." The Court decided that "forward agreement" is an even broader concept than "forward contract" and ruled that a forward contract for physically-delivered gas between an intermediary and an industrial end-user could be a "commodity forward agreement," and thus a "swap agreement" subject to safe-harbor treatment, notwithstanding that the contract was *not* a financial derivative traded on financial markets. Thus we can add one more opinion to the short list of favorable cases to be cited to whenever energy trading contracts (such as NAESB's) need safe-harbor treatment in bankruptcy.

> **"Because we conclude that every 'forward *contract*' is also a 'forward *agreement*,' it follows that we must reject the district court's assumption that all of the agreements in Section 101(53B)(A)(i) must be 'found in the financial markets.' ... Numerous courts have found that 'forward *contracts*' may be physically settled, and it follows that 'forward *agreements*' may likewise be physically settled."**

Moral: It ain't a forward contract until the Bankruptcy Judge says it's a forward contract.

Bankruptcy Code § 546(e)

(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.

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.

Nuggets of wisdom from Chapter 7 Bankruptcy Trustee Daniel J. Goldberg of the Eastern District of Texas: "Although there are potentially other Bankruptcy Code elements for the Trustee to prove in Court, I routinely assume in practice that all payments made within 90 days to creditors and within one year to insiders are preferences, unless shown otherwise. What will it cost the creditor to fight the action versus what is the likelihood of settlement by the creditor? Preferences are a fertile area for compromise settlements that bring relatively easy money into the Estate."

VIII. CONCLUSION

The foregoing information is for educational purposes only and is not intended to exhaustively or conclusively cover the limitless possibilities for bankruptcy disputes between Trustees and creditors. Bankruptcy law is subject to change and all of its nuances, details, and exceptions cannot be covered completely in any short outline. Trustees are often human beings, so any effort to generalize about their motivations is bound to be met by exceptions and uncertainties. Most importantly, this outline is no substitute for legal advice.

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